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20010127

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Business this week

Jan 25th 2001
From The Economist print edition

Furse past the post

The **London Stock Exchange** appointed Clara Furse as chief executive to replace Gavin Casey, who resigned last September. As the first woman to run the LSE, she comes with a reputation for toughness, a quality she will need in abundance if she is to maintain the exchange's position as a leading centre for share trading.

See article: Clara Furse, the London Stock Exchange's surprise new boss

Deutsche Börse announced the terms of its initial public offering in February. The Frankfurt exchange, which failed in its attempt last year to merge with the LSE, will be valued at up to *euro*3 billion ($2.8 billion) when it floats just under a third of its shares.

Merrill Lynch, an American investment bank, led the "bulge bracket" with fourth-quarter profits of $877m, up by 11% over the previous year; and profits for the year up 41%, surpassing analysts' expectations. This performance came despite Merrill's slippage down the investment-banking league tables. Cost-cutting and gains from underwriting and corporate finance did the trick.

PCs plod

Concern about the slowdown in the **PC market** increased. Data from Context, a research firm, showed European PC shipments up just 6.9% in the fourth quarter of 2000, compared with 11.7% in the previous year, which had suffered from dramatic pre-millennium-bug spending cuts. In the two preceding years, shipment growth had exceeded 20%. Less frequent replacement and alternative ways of accessing the Internet were offered as reasons.

Dell Computer issued a profits warning for the fourth quarter of 2000. The world's second-biggest PC maker had cut prices, raising market share in a slowing market. **Compaq** suffered fourth-quarter losses after falling demand and a write-off of $1.8 billion, due mostly to the lower value of its Internet investments.

Orange, a mobile-phone company owned by France Telecom, announced the terms of an initial public offering of up to 15% of the company. Orange will be valued at up to *euro*65 billion ($60 billion), less than half France Telecom's estimate of what it would fetch when it bought the company last year.

Lucent Technologies, the world's biggest telecoms-equipment maker, made losses of $1 billion in the quarter to the end of December. It said that it would shed 10,000 employees and cut costs by $2 billion in an effort to restructure the company and return it to profitability.

Media-Most, a Russian broadcaster indebted to a part-state-owned gas monopoly, Gazprom, was offered a $320m life-line by a group of investors led by Ted Turner, an American media tycoon. The

consortium wants a 25% stake in NTV, Russia's largest independent TV channel, as well as shares in its other media outlets, so long as NTV stays free of state interference. Russia's government would not offer such reassurance.

Not content with prolonging just one dynasty, George Bush has promoted Michael Powell to chairman of America's **Federal Communications Commission**. He is the son of Colin Powell, America's new secretary of state. As a member of the FCC he voted to approve the merger of Time Warner and AOL, an Internet company on whose board his father served.

Deliver us from DHL

Two rival delivery services, **FedEx** and **United Parcel Service**, are trying to stop the Belgium-based **DHL International** expanding in America. FedEx claims that DHL Airways, part-owned by DHL International, would be more than 25%-owned by a foreign entity, which is a breach of America's federal requirements. DHL International is itself controlled by Deutsche Post which is part-owned by Germany's government. UPS's ploy is to claim that cash from Germany's mail monopoly would be used unfairly to finance an assault on America.

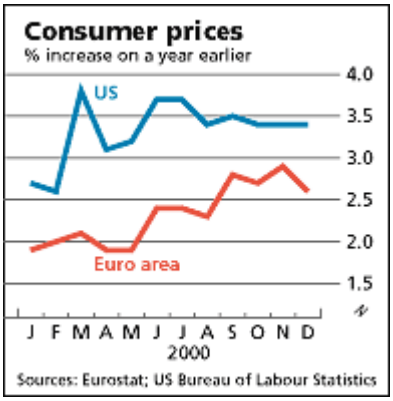
Unilever, an Anglo-Dutch consumer-goods giant undergoing a radical restructuring, is planning to raise $2 billion from the sale of its American bakery business and some European food brands. The sales are a condition imposed by European regulators after Unilever's acquisition of Bestfoods for $21.3 billion last year.

Kirk Kerkorian, a corporate raider and **DaimlerChrysler**'s third-largest shareholder, reportedly sold half of his 3.3% stake in the company. He is pursuing the car maker through the courts for "fraudulently inducing the 1998 vote of Chrysler shareholders" by claiming the deal with Daimler was a merger of equals. Despite the sell-off, DaimlerChrysler's shares have appreciated of late.

RWE, Germany's biggest utility, is among a number of firms interested in buying **Hidroelectrica del Cantabrico**, Spain's fourth-largest electricity generator. The purchaser will bein a good position to mop up assets divested after the merger between Spain's two biggest power groups, Endesa and Iberdrola.
See article: German utilities' Wanderlust
Philippe Bruggisser resigned as chief executive of **SAirGroup**, the parent company of Swissair. The group's investment in smaller European airlines had made it Europe's fifth-largest carrier but has also hit profits. The company is likely to sell some airline stakes or its hotel business.
See article: Europe's beleaguered airlines

High prices

Inflation in the euro area slowed in December to 2.6% on a year earlier, compared with 2.9% in the previous month, prompting speculation that the European Central Bank may soon cut interest rates. Germany's Ifo index of business confidence declined for the seventh month in succession in December, reflecting growing gloom about prospects for the European and world economies.



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The World this week

Jan 25th 2001
From The Economist print edition

Bush sworn in

EPA

After being sworn in as America's 43rd president, **George Bush** appealed especially for civility among Americans. As his first initiative, he proposed sweeping changes to America's schools, including the annual testing of elementary-school pupils and the use of vouchers to help parents of children in bad public schools to pay for private or religious education.

See article: Bush starts with education

Mr Bush also said he would restore Ronald Reagan's policy of denying federal money for the promotion of **abortion** abroad. Many other last-minute Clinton regulations were blocked or suspended, including the creation of several new "national monuments", or protected areas, in the west.

See article: Abortion heats up again

President **Bill Clinton** left office with immunity from criminal prosecution and a flurry of pardons, including pardons for his half-brother Roger, Patty Hearst and a fugitive oil-trader, Marc Rich.

See article: Marc Rich's outrageous pardon

An oil slick from a stranded tanker threatened rare wildlife on Ecuador's **Galapagos Islands**. Winds and tides proved more effective at dispersing the oil than official efforts had been at preventing it from spilling.

See article: Bungling in the Galapagos

In **Colombia**, the FARC guerrillas rejected a government request to restart peace talks and stop kidnappings and bombings. But efforts continued to try to revive the stalled peace process.

See article: Sustaining Colombia's peace process

The Sandinists named Daniel Ortega, **Nicaragua**'s president for much of the 1980s, as their candidate for a presidential election due in November.

General Augusto Pinochet was questioned at home by a Chilean judge investigating claims against him of murder and kidnapping. The former dictator was reported to have said that he had not ordered any killings.

Another Kabila

EPA

In **Congo**, after a state funeral for Laurent Kabila, the country's assassinated president, parliament rubber-stamped the appointment of his son, Joseph, in his place. Around 200 people were massacred in the north-east of the country.

See article: Congo gets a new president

President Olusegun Obasanjo of **Nigeria** dissolved his cabinet and promised to name a new one soon.

Charles Taylor, the president of **Liberia**, offered to resign if a United Nations investigation could prove that he had benefited from sales of illicit diamonds from Sierra Leone. The UN considered applying sanctions to Liberia.

Israel suspended talks with Palestinians in Egypt after Palestinian gunmen killed two Israelis. But the two sides did not entirely give up hope of striking a deal before Israel's election on February 6th.

Islamic militants killed a family of 11 in **Algeria**, raising the week's toll of deaths to 62 and bringing the current spate of violence into its second month.

Army manoeuvres

EPA

Gloria Macapagal Arroyo became president of the **Philippines** after army generals switched their support from the elected president, Joseph Estrada. Mr Estrada, whose opponents said he was incompetent and corrupt, suggested he might try to retake power.
See article: A coup in the Philippines
In the **Falun Gong**'s latest protest against Communist authority, five members of the spiritual cult doused themselves with petrol and set themselves ablaze in Tiananmen Square in Beijing. One woman died.
See article: Suicide in Tiananmen Square
The sickly government of **Japan**'s prime minister, Yoshiro Mori, was dealt a new blow by the resignation of the economics minister, Fukushiro Nukaga, in connection with a bribery scandal. He was the third minister to resign from the Mori government since its formation ten months ago.
See article: Another Japanese minister goes
India extended its two-month-old ceasefire in the part of **Kashmir** that it administers. Pro-Pakistan guerrilla groups said they would continue to ignore the truce.
See article: India extends its Kashmir truce

Elfin charms

The trial began in Paris of **Roland Dumas**, a former foreign minister, and his ex-mistress, Christine Deviers-Joncour, and others, on charges of corruption. Mr Dumas is alleged to have secured Ms Deviers-Joncour a job as a lobbyist with Elf, a state-owned oil company, and to have received payments from her of money she had received from the company.
See article: The Mitterrand era on trial

The chief prosecutor at the United Nations war-crimes tribunal in The Hague, **Carla Del Ponte**, abruptly broke off talks with President Vojislav Kostunica of Yugoslavia during a short visit to the country. Her efforts to persuade Mr Kostunica to co-operate on the extradition of war criminals, in particular ex-President Slobodan Milosevic, were apparently rebuffed.

AP

Peter Mandelson, Britain's Northern Ireland secretary and a powerful member of Tony Blair's cabinet, was obliged to resign. He was accused of helping a rich Indian businessman to get British citizenship in 1998 and subsequently being less than clear about his involvement.
See article: Mandelson resigns

President Vladimir Putin announced plans to withdraw 80,000 troops from Chechnya over the next few months, cutting Russian strength there by three-quarters.

The European Commission put pressure on **Ireland**'s government to adopt less expansionary economic policies. It was the first time the commission had thus used its powers to intervene in a member's budgetary affairs.

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Debt trap!

Jan 25th 2001
From The Economist print edition

THE shadows looming over the world's rich economies show no sign of lifting. In the biggest, the United States, the new Bush administration has talked openly of a downturn, and even of recession. The second-biggest, Japan, is teetering yet again on the brink of a recession of its own. It is true that, for now, the outlook in Europe appears more hopeful. But the risk that everything on the economic front could go wrong this year remains real. It is most pronounced in America; and its most fearsome guise is as a debt trap. In simplified terms, the big worry is whether America might follow a similar road to that taken by Japan ten years ago: a burst bubble followed by a deep and prolonged recession, or even slump.

Judging by the ingrained optimism of most American economic commentators, such a worry might seem risible. A year ago, most believed that America's ten-year expansion would continue indefinitely. Now, after the bursting of the Nasdaq stockmarket bubble, and with the economy slowing sharply, a few admit to a risk of a mild recession. But almost all expect a bounce-back later in the year, as monetary easing works its charm. They see no chance that America's economy could collapse in the same way as Japan's. After all, the two are completely different. Aren't they?

A tale of two bubbles

On the surface, the answer seems to be: yes. American banks are sounder than Japan's were at the height of its more-pervasive bubble. The Japanese investment and stockmarket booms in the 1980s were based on the flawed notion that Japan had invented new economic laws—whereas America's faster productivity growth, driven by the high-tech revolution, looks more real. And Japan's decade of feeble growth can be blamed on policy errors more than on the bursting of the bubble itself. Japan's policymakers failed to encourage enough monetary expansion or to purge the country's banking system (see article). While an appropriate policy response cannot entirely be counted upon in America, the prospects look better than in the murky politics of Japan.

All that said, there are enough eerie similarities between America today and Japan in 1989-90 to be worrying. The biggest is excessive debt. Too much debt was always at the heart of Japan's weakness. So it is alarming that America's boom has also been fuelled by massive borrowing by companies and households. Our survey of corporate finance in this week's issue explores how American firms' borrowing binge has left lenders exposed to some nasty risks. And, as if corporate debt is not alarming enough, consumer borrowing has been even more rampant. By borrowing against paper gains in share values, households have been able to shop until they dropped, not bothering to save.

Optimists retort that private-sector balance sheets look healthy, because the increase in debt has been more than matched by increased assets. However, balance sheets also looked remarkably healthy in Japan in the late 1980s—until asset prices tumbled. On most historical measures, American share prices remain heftily overvalued. A lot of consumer and corporate debt has been incurred on the assumption of everlasting growth and rising share prices.

The notion that America's bubble has been smaller than Japan's also needs qualifying. Japan's excesses depended chiefly on crazy property prices, while American property has remained fairly sane. But the corresponding boost to debt and consumption in America has come from the stockmarket. At the market's peak, American households owned shares worth 175% of their disposable income, much higher than Japanese households' shareholdings at the Tokyo market's 1989 peak of only 90% of their income.

Just as Japan's crash led Japanese consumers to raise their savings and cut spending, so the risk is that the same could occur in America.

Plus ça change

Japan, in short, is not unique. America is but one more example of an age-old phenomenon, in which rapid increases in asset prices encourage a credit binge and overinvestment that prove unsustainable once asset prices fall. It is no coincidence that the deepest and most protracted recessions in recent decades have taken hold in countries that experienced booms in property or share prices and a large build-up of debt, such as Britain and Sweden in the early 1990s. This is not to deny that the IT revolution has lifted America's productivity, nor that this might justify some of the increase in share prices and hence some of the extra debt. But it would not justify nearly enough of it to eliminate the risk of recession.

What about the argument that America has ample monetary and fiscal ammunition? America certainly has more scope to cut interest rates and taxes than today's Japan, where interest rates are already near zero and the government has a massive budget deficit. But Japan had plenty of scope to do both in 1990, when interest rates were at similar levels to those in America today, and its budget surplus was then even bigger as a share of GDP. Japan was slow to cut interest rates, but that was because its economy continued to boom for almost two years after the stockmarket bubble had burst. Although fiscal and monetary easing may be able to prevent disaster, they may not be enough to prevent a recession, especially if there is a large overhang of debt.

Alan Greenspan, the chairman of America's Fed, does at least have the advantage of being able to learn from Japan. He would surely avoid the error of allowing deflation to take hold. Even so, the Fed, whose policymaking committee meets next week, faces a dilemma over when and how quickly to cut interest rates. Ease too soon and by too much, and either the bubble could reflate, paving the way for an even harder landing in future, or the dollar could collapse. Ease too late, and America could come to look horribly like Japan.

America has a good chance to escape the full, stagnant fate suffered by Japan during the 1990s. But the more that the debt trap is ignored, the more the risks will rise.

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Education betrayed

Jan 25th 2001
From The Economist print edition

Many Americans say that the new administration's education plan is too bold. Actually, it is much too timid

Get article background

AP

GEORGE BUSH, striving already to give substance to "compassionate conservatism", has made education his first order of business. Fine: American education needs reform. On January 23rd he sent Congress his first legislative proposal, a plan to spend more on schools, with measures, he says, to ensure that the money gets results. The president wants children to be tested each year in maths and English. Schools, districts and states that improved their performance would get more cash; the others would face, in effect, a financial penalty. States would be given more flexibility in the way they spend some federal education money. And, almost as an afterthought, Mr Bush advocates a limited voucher plan, which would help some poor parents of some poor students in some failing schools to pay for private tuition, maybe.

The educational establishment—the teachers' unions and, to the extent these two can be separated, the Democratic Party—applauded the early emphasis on more money for schools, but deplored the partisan, divisive, immoderate, knee-jerk, reckless, ideological idea of allowing a few parents a bit more say in their children's education. The timidity of the plan's thinking on vouchers, and the hostility that greeted even that, spell doom for hopes that a Bush presidency might transform American education. The opportunity to do it is at hand, or so it seemed. It isn't going to happen.

A better bureaucrat

When Mr Bush presented his plan, his remarks were widely seen, with reason, as signalling willingness to drop vouchers altogether. He avoided uttering the v-word. He promised to work with the Democrats, and they are ready with a plan of their own, quite like the president's, except that the voucher part is excised. Their formula—"invest in reform, insist on results"—is regarded as radical in the party. (That "insist on results" part, you understand, could be construed as holding teachers to account in some way, which must be a mistake.) But the truth is that more spending plus more targets is not a new approach: it is only an improved version of the old approach. Welcome though improvement may be, it is not the bold departure that is needed.

Yes, it makes sense to tie additional funding to performance targets: susceptible as they may be to evasion or manipulation, such devices are better than more money with no strings attached. But what is missing is the all-important pressure to compete for the business of individual, empowered consumers. That pressure is what makes the private sector of the American economy the most vibrant in the world. It is responsible for the excellence of America's universities. And lack of it is a main cause of bad schools. Vouchers, with generous funding, are the best answer. The evidence that greater parental choice, however arranged, raises standards is already persuasive (see article). On all this Mr Bush seemed convinced. How did this chance come to be missed?

The president would answer that the strength of opposition to market forces in education is daunting (see article), especially for an administration forced to collaborate with moderates from the opposing party. What is so disappointing, however, is that such a collaboration ought to have been possible on this issue. The Democratic Party is not entirely monolithic on vouchers: the idea commands support, interestingly, among black politicians familiar with the desperation of families trapped in the educational ghettos of many American cities, who see vouchers as the best way out. The charge that these Democrats should

have levelled against Mr Bush's voucher plan is that it offers too little money to make school choice a reality even for the targeted parents, let alone for parents in inner cities more generally. It is too timid, not too bold.

Nobody on the left is saying so. That is a betrayal of the children that the American economic miracle will continue to leave behind. And all the centrally managed targets and top-down accountability in the world are not going to put it right.

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Britain's MMR scare

Jan 25th 2001
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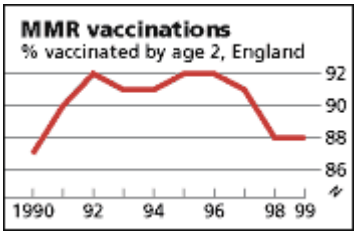
Public-health authorities owe citizens unspun information and a measure of respect. Official propaganda scorns both



BRITAIN is in a renewed state of alarm over the combined MMR vaccine, routinely given to children to guard them against measles, mumps and rubella. Campaigners have long expressed the fear that the triple vaccine is linked to bowel disease and autism; successive governments have insisted it is "safe". Post-BSE, official reassurance on health and safety was already a badly devalued currency. Now further doubt has been cast—at least in the minds of many parents—by a new report which attacks the way the vaccine was tested and which takes seriously the possibility of a link with autism. Even before this latest development, many British parents were refusing the vaccine. As the proportion of children immunised, currently 88% and falling, continues to drop, the risk of a return to the epidemics of old steadily mounts.

All this presents a tangle of difficult issues. In the middle lies a dilemma for liberals and public-spirited parents alike. Suppose, as seems likely, that the new report is a badly flawed piece of work (see article). Suppose, as also seems likely, that the MMR vaccine is indeed "safe" in the ordinary meaning of the word: that is, the risk of harmful side-effects, while not zero (unattainable for any vaccine) is tiny—and negligible when set against the benefit of protection from measles and the rest, which are not just unpleasant illnesses but capable of disabling and even killing. The dilemma which then arises is this: once MMR has all but eradicated measles, the risk of an unvaccinated child catching the illness is virtually zero. Why then should any given parent expose a child to the risk, however small, of the MMR vaccine? The temptation is to "free-ride" on vaccinations dispensed to other children. Once this idea establishes itself, as it has begun to in Britain, ever fewer parents choose the vaccination—until, that is, epidemics of measles start killing and crippling all over again.

The public-health professional, keen on "efficiency", and guided by the idea (warranted, up to a point) that he knows more about this than the population as a whole, responds in two ways. First, move as close to compulsory vaccination as public opinion will allow. In Britain this takes the form of severe restrictions on the availability of the alternative course of (allegedly safer, in practice less effective) single vaccines. Parents are told, in effect, MMR or nothing. Second, wage a propaganda campaign, economising on truth, never qualifying the word "safe", telling parents whatever it takes to get them to do the right thing for the community at large.

As Britain is discovering, this approach has drawbacks. For a start, it tramples on people's rights—not that this would keep too many officials awake at night. Also, more serious according to their view, it isn't working. Quasi-compulsion plus propaganda barrage is failing even on its own terms, thanks to a probably irrecoverable loss of trust in "experts" in any way connected to the government. But at this point liberals do get confused. It is good that people repudiate disguised coercion and sugar-coated "information". It is not so good if the consequence will be more children exposed to unnecessary suffering and death, at least as compared with the alternative of universal immunisation. What is the answer?

The trouble with freedom

In a free society, where officialdom cannot monopolise knowledge, governments must deal with people as if they were intelligent adults, inconvenient as this must be. It is a matter both of what is right and, nowadays, of what is feasible. Actually, offered an open debate and an unvarnished presentation of the facts, it is a fair bet that the proportion of parents choosing MMR would rise, even without the spur of new outbreaks of measles. But if a combination of free-riding and old-fashioned ignorance keeps the

proportion of children immunised far below 100%—admittedly, on present knowledge, a less-than-ideal collective outcome—well, that is the price of freedom.

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Russia breaks its word

Jan 25th 2001
From The Economist print edition

If it goes ahead with its plans to sell nuclear reactors and uranium fuel to India, Russia will be in clear breach of its anti-proliferation promises

TO HEAR President Vladimir Putin tell it, Russia leads the world in its efforts to rein in weapons of mass destruction and—glaring hard at America and its proposed missile defences—to prevent a new arms race. Last year it ratified the Comprehensive Test-Ban Treaty that America's Senate had rejected, and that China's parliament is still pondering. It also belatedly ratified the Start-2 nuclear-reductions treaty with America. And, after a lot of American chivvying about dodgy nuclear- and missile-technology exports by Russian firms, new export controls were published. So why is Russia proposing to drive a nuclear-propelled coach and horses through the guidelines of the Nuclear Suppliers' Group (NSG) and its commitments to other members of the Nuclear Non-Proliferation Treaty (NPT) by selling up to four nuclear reactors to India, plus uranium fuel for a fifth?

If Russia goes ahead, it would break no actual treaties. In 1993 the NSG, an informal group that includes Russia and most major suppliers of nuclear equipment, decided to ban all nuclear trade with countries that did not have international safeguards on all their nuclear facilities, thus committing its members to action well beyond their existing export controls on goods that might help a country build nuclear weapons. Two years later, most NPT members reached a similar agreement. India refuses "full-scope" safeguards, has never joined the NPT, which legally requires them, and in 1998 conducted five nuclear-weapons tests.

Russia claims that the "full-scope" rule does not apply to its proposed sale of nuclear reactors to India, since the idea had come up in the late 1980s—that is, before the NSG ban. That is wholly disingenuous. The contracts being negotiated break the rule. So does what is presumably the sweetener for the deal: the supply of uranium fuel for India's Tharapur reactor. America stopped supplying its fuel after India's first, supposedly "peaceful", nuclear explosion in 1974; France pulled out to comply with the "full-scope" rule; only China, outside the NSG, has in recent years helped India find nuclear supplies it could not get elsewhere.

Fission for compliments

Part of the explanation for Russia's nuclear dalliance with India lies in the fissile nature of its own politics. Russian firms, following up old Soviet connections and often with the connivance of officials who are supposed to police them, have been implicated in illegal transfers of missile and nuclear technology to several countries. Russia's minister for atomic energy has a foreign policy all his own: he wanted to sell laser enrichment technology that could help in bomb-making to Iran (which has signed the NPT but barely disguises its weapons ambitions). Already building one reactor in Iran, Russia hopes to build more. Foreign-ministry officials who see the dangers are overridden in the drive for contracts, as they were recently by the arms industry's desire to sell conventional weapons to Iran, despite Russia's promise not to do so.

In their defence, Russia's nuclear bureaucrats claim the best way to influence nuclear programmes in countries like Iran, and also India, is to work with them. More likely, when scientists sit down together, what gets passed on is not restraint, but skills and know-how of direct use in bomb-making. That is how India first got started on its bomb.

Mr Putin seems intent, for now, on making life as uncomfortable for America as possible—in India, Iran or

anywhere else. India would prefer nuclear help from France or America, and hopes the bait of its deals with Russia may eventually draw them in. But India could just as easily get caught in the crossfire on this issue between the bigger powers.

If Russia is determined to go ahead, can anything be done to stop it? Another of Russia's commercial wheezes is a plan to build an international repository for spent nuclear fuel. Already controversial, given the lousy safety record of Russia's nuclear industry, this could be made a non-starter if Russia's nuclear co-operation with countries like India and Iran causes America and others to lean hard on potential customers. But pressure must also be put directly on Russia itself. It is threatening to turn its commitments on nuclear export-controls into a cheater's charter. Countries that care about proliferation should not let it get away with it.

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Showdowns in South-East Asia

Jan 25th 2001
From The Economist print edition

The removal of the Philippines' president was a good deed, done the wrong way. Other South-East Asian countries should take note

AP

AS HE stumbled out of Malacanang Palace, beaten, confused and by most accounts badly hung-over, President Joseph Estrada of the Philippines cut as sorry a spectacle as he had in office. Swept into power in 1998 on promises to defend the little guy, as he had so often done in the B-movie roles from which his political career was launched, he had ended up not so much protecting the underdog as robbing him. It is ironic that the allegations that brought Mr Estrada down concerned pay-offs from operators of *jueteng*, an illegal numbers racket aimed at the Philippines' poorest, and the skimming of taxes on tobacco.

Having presided over a collapse in his country's stockmarket and currency, as well as a worsening rebellion in its separatist south, Mr Estrada is no loss to an office that he never got to grips with. But there is much to regret in the manner of his passing, which serves as a reminder of how far the Philippines still has to go before it can be regarded as a nation of laws, not of men. For all the talk of "people power" and triumphs of democracy, the democratically-elected Mr Estrada was removed by what amounted to a bloodless coup, backed up with a bit of mob law, after the prescribed constitutional process had shown itself to be deficient.

Mr Estrada at no point formally resigned. He now says he has "strong and serious doubts" about the legality of the transfer of power. His Senate trial, which aimed to remove him from office by the only legal method, collapsed in disarray after loyalist senators refused to allow bank records that the prosecution said would prove his guilt to be admitted as evidence. The army transferred its loyalty to Mr Estrada's estranged vice-president only after its top brass were warned by junior officers of the prospect of military action on the streets of Manila were Mr Estrada to stay. No doubt the men in khaki were acting for the best, but, like Cory Aquino before her, Gloria Macapagal Arroyo takes office with the uncomfortable knowledge that the armed forces helped put her in power. Mrs Aquino went on to face a string of attempted coups that nearly toppled her.

All that said, Mrs Arroyo's own democratic credentials are not in doubt, which makes this coup a big improvement on the usual kind. Elected vice-president in her own right with a record share of the popular vote, Mrs Arroyo has performed well as an administrator and a senator. She ought at least to know her way around the presidential palace, having partly grown up there while her father, Diosdado Macapagal, held the job of president, bravely tackling corruption and land-reform before being defeated by Ferdinand Marcos in 1965.

As for the father, so for the daughter: the war on corruption should be among Mrs Arroyo's top concerns. Corruption, after all, is what has brought down Mr Estrada. And allegations of corruption also threaten both the president of Indonesia and the prime minister-elect of Thailand, who faces disqualification for failing to report all his assets. However embarrassing, such scrutiny is no small sign of progress in a region that still needs to clean up its politics. A free press, probing as never before the finances and doings of once-untouchable leaders, has proved central to all three cases.

Indonesia, as well as its president, on trial

This newspaper, on the whole, has a lot of time for Abdurrahman Wahid, a brave man who consistently pushed for greater democracy during the autocratic rule of General Suharto in Indonesia. In office, he

has tried hard, though with only partial success, to get the army out of Indonesia's politics, and to tread the difficult line between devolving power from the centre and seeing his country fly apart. But (see article) Mr Wahid has a bit of explaining to do himself on two biggish scandals now before parliament: so far, he has acted more as though he has something to hide than as a man concerned to show that, in a democracy, presidents can be held accountable. And on past occasions, too, he has appeared to act high-handedly, sacking and appointing ministers in ways too reminiscent of his predecessor.

Next week, the stage is set for a showdown between Mr Wahid and his critics in parliament: impeachment is not being ruled out. Were Indonesia's first democratically chosen leader to be removed from office on corruption grounds, that would be a matter for regret by democrats everywhere, and a boon to Indonesian reactionaries who claim their country is too sprawling and young to adopt democracy. But were the process to be sound in constitutional terms, a regrettable outcome ought not to be seen as a setback for democracy. It would be very different from the story in the Philippines, where a good result has been tainted by bad methods. Better, of course, if neither country had had reason to doubt its president. But where such doubts warrant action, the procedure must be properly constitutional if democracy is to take root.

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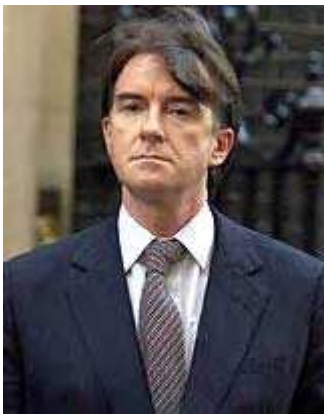
After Mandelson

Jan 25th 2001
From The Economist print edition

Get article background

Hit by scandal, Britain´s Northern Ireland secretary had to go. But his departure will put new burdens on Tony Blair

AP



POLITICS, it is occasionally tempting to think, is a cruel sport. One moment you are sailing merrily along, miles ahead in the opinion polls, an election almost near enough to touch, and opposed by a party of quite remarkable ineffectiveness. Then, out of nowhere, a storm appears, tossing one of your best and most loyal crew members over the side, for the second time in two years. And all over the footling matter of a two-minute phone call on behalf of a rich Indian businessman called Srichand Hinduja, who had been kind enough to support one of your pet projects and simply wanted a British passport. It all seems so unfair.

Fortunately, that temptation can quite easily be resisted. For the ejection on January 24th from Britain's government of Peter Mandelson, the secretary of state for Northern Ireland and one of Tony Blair's closest allies, was richly deserved. Two years ago, when he first resigned from the government over a home loan accepted from a wealthy colleague, he showed an arrogant disregard for the conflict of interest that arose when his own department began to investigate that same colleague. Then he compounded the sin by lying about it, and concealing it even from the prime minister. Now, having been "cleansed" by an all-too-brief leave of absence from the cabinet, he has done the same thing again. He had to go, both because of his sins and because otherwise Mr Blair would have looked ridiculous.

Were his sins really that bad? By all accounts, Mr Mandelson has done a good job in Belfast. But as a politician, he has been fatally flawed. His phone call on behalf of Mr Hinduja's passport application, even if it is shown to have merely been a technical enquiry, was clearly intended to put pressure on the Home Office (or to make Mr Hinduja think pressure was being applied) to grant citizenship to a man who had donated £1m ($1.5m) to support the Millennium Dome. This was improper, even if a cynical public will not be surprised to hear of such favours being done for the rich. It was arrogant to think that news of it would never emerge. And then it was plain, suicidal stupidity to lie about it once the news got out, even to Alastair Campbell, the prime minister's spokesman. This was just the appearance of impropriety and disloyalty, Labour's Mandelson-trained spinners will say, not real impropriety itself. Humbug. If there was nothing improper to conceal, why bother to conceal it?

For Mr Blair, the best thing that can be said about Mr Mandelson's departure is that it happened quickly, making the prime minister at least look decisive and in charge. Most probably, unless further muck comes to light, this affair will have little influence on the outcome, or even the timing, of the general election, which remains likely to take place in May and be won by Labour. But even to have risked such an influence will be giving Mr Blair (and Mr Campbell) the collywobbles. And some of Mr Mandelson's sins may come also to be associated with his patron: an excessive cosiness with the rich and powerful; the sense that status and influence are for sale; the arrogance to believe that doing a job well is enough to neutralise any improper behaviour. For a long time, Mr Blair could pose to the public as a leader who was both saintly and competent. This week's events have cast a shadow over both those words.

It will also, however, cast a shadow over Labour's whole second term. For Mr Mandelson's departure will alter the balance of the government: it removes the most vocal advocate of closer integration into Europe; it removes the original kingpin of New Labour's project to realign British politics by cosying up to the Liberal Democrats; and it removes the only heavyweight in the cabinet who Mr Blair seemed really to trust. In short, it will put even more of the onus on the prime minister himself.

From New Labour to Middle-aged Labour

What is curiously unclear, though, is whether Mr Blair is capable of taking on such a burden, or willing to. This is curious because Mr Blair has famously run quite a presidential sort of government. But, compared with President Thatcher at least, he has not yet shown much of a willingness to go out on a limb, to pull his colleagues and party firmly to where he wants them to go. Or even to show quite where that place is.

Some commentators this week have compared Mr Blair's trouble with Mr Mandelson to Margaret Thatcher's decision, in 1989, to ditch her chancellor of the exchequer, Nigel Lawson, when he fought with her close advisers. But there was a crucial difference. She disagreed on policy with Mr (now Lord) Lawson, whereas Mr Blair agrees with Mr Mandelson on almost everything. The man he may well disagree with during the second term is his chancellor, Gordon Brown.

As long as they are united, this will be a strong government, with two powerful individuals at its core. But they may well disagree if Mr Blair, shorn now of his chief pro-European, wants Britain soon to join the European single currency. They might also disagree in future over taxation and spending, with Mr Brown keener than Mr Blair to pull the government towards the left during the second term, reaching out to core supporters through redistributive taxation and higher public spending. If Middle-aged Labour is to stay in the centre or the centre-right, to move closer to Europe, to move closer to or even merge with the Lib Dems, the onus, increasingly, will fall on one man and one alone: Tony Blair.

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Letters

Jan 25th 2001
From The Economist print edition

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Hidden weapons

SIR—You are wrong to claim that my research used concealed-handgun laws as a proxy for gun ownership (Economics focus, January 13th). Although it is probable that more people will buy guns, concealed-handgun laws can reduce crime even if gun ownership remains constant as guns become available to protect people outside their homes.

It is a mystery why Mark Duggan relies on the current sales of the fourth-largest gun magazine, *Guns & Ammo*, as a proxy for gun ownership when state-by-state survey data are available. My book, "More Guns, Less Crime", used such survey data and found that states with the biggest increases in gun ownership had the biggest drops in violent crime. It is also wrong that *Guns & Ammo* concentrates on handguns, an important part of Mr Duggan's argument. From 1980 to 1998, 50% of its gun reviews were on long guns. If one really wanted something measuring handguns, the same publisher also produces *Handguns*. Other handgun magazines are available.

While there have been a number of papers discussing my research, including a few critical ones, the debate has been over the size of the benefits of concealed handguns. Critics claim small or no benefits, but many others found large drops in crime, some even larger than those which I had found.

JOHN LOTT
Yale University
New Haven, Connecticut

SIR—Mr Duggan has fallen into that age-old trap well known to investors and economists—back testing. He has shown that gun magazine sales are correlated with higher rates of gun-related death. Fortunately, the remedy is obvious—ban gun magazines.

MARK DAVIS
West Chester, Pennsylvania

Interventionism

SIR—I agree that some wars of intervention are warranted, that rules are required to govern them and that ample discretion is needed to apply the rules ("Why and when to go in", January 6th). However, this discretion is not exercised by the 100-plus democracies of the world; it is exercised by America and its European allies. As they further their interests in the process, the dissuasive effect of interventions is reduced; some despots know that their good relations with the West shield them from bombing if not from a slap on the wrist.

Unless westerners become enlightened rulers—a utopia—your recipe needs an additional ingredient: bolstered multilateralism, with an independent army democratically controlled by all the world's democracies.

DIDIER JACOBS
Cambridge, Massachusetts

SIR—You are on the right track with your idea of a coming global marketplace of ideas where

imperfections in the market—offences against democratic virtue—are known for what they are. But experience shows that the market mechanisms, or the people using and building them, are not so sophisticated, yet. Indeed, the cost of intervention is often too high, but that is what an economist would predict in a case of market imperfection. The cure can be worse than the disease when you do not know what the hell you are doing.

An honest rule always includes the caveat: if it is easy. When the world is indeed transparent enough that we cannot only see what our neighbours are going through but an easy way to help them, then we can speak of a new obligation imposed by a new level of technological and cultural sophistication. Before that happens, intervention is at best an "evangelical counsel". We should help if we can but "a doubtful obligation does not bind."

CHRIS RUSHLAU
Portland, Maine

SIR—Your proposed criteria would have called for intervention in America's civil war—on behalf of the South.

JOHN KWIATKOWSKI
Indianapolis

Fundamental bias

SIR—Bagehot's claim (January 6th) that *The Economist* has never been market fundamentalist is as disingenuous as Clare Short's claim always to have supported "effective states and efficient markets". As with all fundamentalists it is normal to claim to be moderate. A selection of your moderate views might include those on privatising health, education, and road, rail and air-transport systems. It seems a market view is always advocated. Bagehot claims to favour effective states—but rarely is serious attention given to the steps needed to obtain them in countries without a basic level of administrative organisation and literacy. "Let the market decide" is promoted instead. In developed nations efforts to obtain effective states are derided as "big government" and free markets advocated—witness support for George Bush and the EU constitution.

NICHOLAS LEAKE
London

Greenspan's credit

SIR—Regarding the Federal Reserve's recent move to lower interest rates, I suspect that you are missing the aim of Alan Greenspan's actions somewhat: he is concerned about markets, but credit markets not equity markets ("Greenspan's big surprise", January 6th). He has said that he cannot be in the business of managing equity bubbles, but he is in the business of managing credit. When debt markets witness the widest spreads seen since the last recession, what do you want him to wait for to happen? An actual recession?

MANISH AURORA
New York

SIR—Your critique of Mr Greenspan's interest-rate cut does not weigh sufficiently the political calculations behind it. By cutting rates now, Mr Greenspan can counsel a go-slow or abandonment of George Bush's irresponsibly large tax cut. Better a slightly deeper slash with a (comparative) scalpel than a hard whack with a meat cleaver.

JOHN CLARK
Chicago

The slavery question

SIR—Charles Mills (Letters, January 13th) is right to argue that the present American government is not to blame for slavery and should therefore not have to pay reparations to the descendants of slaves. However, he is wrong to accuse the British government of establishing and maintaining slavery in America. If the British government was to blame for slavery, then why did the Americans, eager to be rid

of the hated institution, not abolish slavery upon independence in 1783, or in 1787, when they were drawing up the constitution? The British abolished slavery in 1833; Americans fought a bloody civil war before the political climate was ready for the 13th amendment in 1865.

If anyone in America should have to pay reparations to the descendants of slaves, it should be the descendants of southern plantation owners or those still-existing private companies that grew rich from slavery.

ASHLEY SMITH
Geneva

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Between this world and the next

Jan 25th 2001
From The Economist print edition

As Pope John Paul II creates what is probably his last batch of cardinals, the Roman Catholic church waits for change. Will it come?

STEP into London's Westminster Cathedral at 8am on any morning, and you will find 60 or 70 people attending mass in a side-chapel. The same number appear at the 8.30 mass, and at the 9 o'clock. Most are on their way to work, but they make a deliberate pause for this. And the scene could be repeated the world over.

The business of the Roman Catholic church is not this world, but the next. Most of those morning mass-goers could not tell you the names of two people in the Curia in Rome. They could not care who is up or down in the Vatican horse-race. They cling to the church as a conduit of comfort, grace and, ultimately, salvation. This is all that matters; and, at base, it is all that matters in the Vatican, too.

The church's long view of human affairs—in fact, the longest possible—makes it a peculiar player on the world scene. Much that it does and says seems clumsy, baffling and, even to some Catholics, inexcusable. *Sub specie aeternitatis,* matters often look quite different. The problems of the church have always stemmed from the attempt to promote eternal truths through the agency of mere humans in a shifting world. That task gets no easier.

EPA

Jubilee's end

An unruly flock

At the last count, in 1998, there were just over a billion Roman Catholics. Ten years earlier there were around 900m. In almost every region of the world, the Catholic proportion of the population has stayed the same. Despite those large Catholic families, the church is essentially standing still: except in Africa, which remains, as for some time, the richest source of conversions.

Look closer, or apply different methodologies, and the figures start to be discouraging. In Brazil, the biggest and most influential Catholic country in Latin America, the proportion of people calling themselves Catholic fell from 93% in 1950 to 83% in 1991, the most recent census; it is perhaps another ten percentage points lower now. And within that 70% or so, large numbers will be Catholic in name only. In every region, mass attendance has been falling for the past two decades as modern life makes it harder to dedicate Sundays to prayer.

The mass itself has become heterogeneous. In Africa ancient animist practices colour the liturgy, despite Rome's efforts to remove them. In the developed world, evangelical practices, such as faith-healing and speaking in tongues, have caught on. In Sao Paulo, the rock-star ministry of Father Marcelo Rossi draws as many as 1m people to masses laced with aerobics.

Politically, Catholics do as they please. Countries once thought to be papal lapdogs now think for themselves: Ireland, for example, has legalised divorce, though cautiously. The disappearance of papal censorship, in the form of the Index of proscribed books, has led many Catholics to assume they have complete freedom of thought and expression. Old structures of prayer and penance have predictably fallen by the wayside since they became optional. Notions of heaven and hell are cloudy. Although, whenever Pope John Paul pays a visit, the faithful turn out in their thousands, his writ does not necessarily run inside their homes. Increasingly, Catholics practise their religion on their own terms.

From the moment he came to the See of Peter in 1978, Pope John Paul II was well aware of this. He knew, too, that much of this chaotic dissent among the laity sprang from the efforts of Pope John XXIII in 1962 to refashion the church for the modern world. Vatican II, the first general council of bishops for almost a century, made startling efforts in every direction, from promoting ecumenism to modernising the liturgy to proposing more consultation. Rather than continue along that risky path, Pope John Paul decided, in large part, to retrench. The eternal verities, he believes, can be restated only through a church that does not change its mind.

There is truth in this, of course. The church's unwavering emphasis on the sacredness of life and the essential dignity of every human person, both favourite themes of Pope John Paul, provides a cast-iron basis for moral action. It enables Catholics to follow a coherent theme of opposition to abortion, euthanasia and the death penalty, and many do. It inspires much charity and social action (if also, sometimes, a blinkered anti-capitalism). The problem comes in the sphere of private sexual conduct: where theological thinking, so carefully honed behind desks in Rome, meets the chaos of human desires in the world outside.

The misery of sex

Two themes, birth control and celibacy, crop up inevitably in any debate on the state of the church. It is sad that they do; they should be marginal. But by mishandling sex, or trying to ignore it, the church has hurt its authority in general.

Birth control was always meant to be handled with more understanding. Catholic teaching on the matter was supposed to be discussed by a special commission in the late 1960s, but Pope Paul VI (not an illiberal pope in many ways) instead wrote it himself, arguing from natural law that the transmission of life should never be obstructed. "Natural" methods of contraception were therefore allowed; artificial ones were not.

It is no exaggeration to say that the church has still not recovered. Birth control was the first issue on which the bulk of the Catholic faithful decided, quite simply, to disobey. It marked a breach in the structure of willing obedience that, once made, could only widen. A Gallup poll of American Catholics in 1999 showed that 80% of laymen, and about 50% of priests, approved of artificial contraception; a poll by the University of Maryland found two-thirds of Catholics agreeing that where their conscience was at odds with the pope, they should follow their conscience. Similar figures can be found all over the developed world.

In the sphere of international policy, the birth-control ruling still marks out the church as an irresponsible and obstructionist voice in any debate on over-population, poverty or, especially, the containment of AIDS. This is a tragedy, since in parts of the developing world the church is often the prime provider of health, education and social services. (In Nigeria alone, it runs almost 300 clinics and hospitals.) The essential work of Catholic doctors and teachers is now undermined by the perception, often untrue, that they will put ideology first. As a result, the church is often not taken seriously on other issues, such as embryo research, where health and ethics collide. In the world at large, as in the private lives of Catholics, the church has lost credibility that it cannot easily recoup. And it knows it.

Wanted: priests

Celibacy, which gets less attention, is an even deeper problem. Again, the attractive theology (that priests give their lives completely to God and their flocks) is undermined by the figures for priestly vocations. Over a decade, these have scarcely moved. In 1988, there were 401,930 Catholic priests in the world; in 1998, there were 404,626. Numbers are rising in Asia, Africa and South America, but falling steadily in the first world. There, as priests die or resign, they are not replaced. In the American archdiocese of Milwaukee, for example, half the parishes are expected to be without priests by 2016. In the developing world, though vocations look healthier, they are quite inadequate for the huge areas that must be served. Some congregations may see a priest no more than twice a year. Everywhere, Catholic schools are losing priests as teachers.

The reasons for this decline are not simple. Many priests leave because they cannot cope with the requirement to be celibate; but perhaps as many leave because of "burn-out" in difficult parishes. Some find they cannot present church teaching on contraception, divorce or remarriage in any way that makes sense to their parishioners. But most seem to leave because they are lonely.

It is true, of course, that in many areas of life Catholics can manage perfectly well without a priest. Vatican II recognised the laity as helpers in the work of salvation by virtue of their baptism; as a result, since the council, lay workers and administrators have streamed into the church, and all sorts of "cells" and "base communities" have sprung up in which laymen can pray together and help each other without benefit of clergy. Yet—that business of the other world again—no layman can perform the central act of the mass, the transformation of the bread and wine into (as Catholics believe) the body and blood of Christ. And that act remains the core and the purpose of the life of the church. Without priests, the whole edifice crumbles.

When the subject of priests is raised, most Catholics are not short of solutions. Many feel that anyone drawn to this difficult and demanding life, an attraction which must be God's doing, should simply be allowed admittance. Catholics in Europe and the United States, by large majorities, consider that the rule (it is not doctrine) should be relaxed. If it were, this would also go some way towards solving another problem that has gravely damaged the church in the eyes of outsiders: the incidence of priests who are sexually involved with women or children and yet are often left by their superiors, undisciplined, in charge of souls.

The Vatican (to use the convenient shorthand for the pope and his advisers) is unmoved by argument on either of these subjects. On birth control, Pope John Paul has gone to pains to restate the official line. On priests, the shortage is acknowledged, but little else. The Vatican feels that the number of sexually erring priests is exaggerated by prurient media, and that is true; they probably account for less than 1% of the priesthood in Britain, though rather more, by all accounts, in Ireland. It is a matter for the local bishop to sort out—competently, or not. A "permissive" priest in the theological sense is far more likely to be disciplined by Rome than one who sins sexually.

If those issues can be swept under the carpet, so can others. In 1999 a devastating book, "The Changing Face of the Priesthood" by Donald Cozzens, a professor of theology from Cleveland, Ohio, claimed that approximately half of all priests and seminarians in the United States were homosexual. The Vatican ignored it. Although many clergy admit privately that celibacy has to be reassessed, it is not on any official agenda. The ordination of married men has been rejected (though, for a while, in a blatant breach of the principle, married Anglican priests were admitted to Catholic orders). The ordination of women has been removed from discussion entirely, on the grounds that Christ did not choose women as his disciples and that the priest, who acts *in loco Christi*, cannot be female when Christ was not. It makes good sense in Rome; less outside it.

The slap of authority

From this point of view, there is no doubt that the pontificate of John Paul II has been frustrating. A strong and charismatic pope, idealistic, inspiring, and one of the cleverest men ever to hold the office, has used his strength chiefly to reinforce the church's most conservative tendencies. First, because he wants to travel the world as a freewheeling pastor (a role he excels at), he has delegated power to the Curia, the central church bureaucracy that exists to serve the pope. This has given many elderly conservatives their heads. Second, the pope has kept a sharp eye on appointments of bishops. Candidates who cannot pass a basic litmus test, such as toeing the line on birth control, are rejected. Bishops already in place find that their five-yearly mandatory journeys to Rome are used less for friendly consultation than to restate the line they should be taking. In any case, since many third-world bishops are still trained for the priesthood in Rome, they effortlessly bring Rome-centred attitudes back to their dioceses.

Tight control of the bishops draws less press attention than the very rare occasions when uppity theologians are silenced, but it has much more impact. Rather than cutting off one line of thought in a small academic circle (or, as can also happen, giving extra publicity to peddlers of views of doubtful value), it stifles innovation at the level of the faithful in their parishes.

When bishops and priests talk about the changes they long for under the next pope, "collegiality" and "subsidiarity" are often mentioned. One of the promises of Vatican II was that the church would become more open and consultative, drawing on the wisdom and experience of local parishes; salvation would become a joint effort in which pope, Curia, bishops and even laity ("the People of God") were working with, and learning from, each other.

In his most recent apostolic letter, issued on January 6th, Pope John Paul noted that this was the sort of church he too wished to see. Many were surprised, but took it as a good sign that the uneasiness with

centralisation had been noted. The pope also said he wanted more consultation. Some subjects will be easier to discuss than others. Morris West, a Catholic writer, put it best: “The church will lose many souls because men in authority want to save their faces, and sometimes to save the faces of dead men.”

Ecumenism has also suffered from the emphasis on papal authority. The effort to be friends with other churches and religions potters on, but as a distant dream. Women’s ordination has shattered the dialogue with all but a rump of Anglicans, though both sides try to deny it. Last September a document known as *Dominus Jesus*, signed by Cardinal Ratzinger, the pope’s chief enforcer of doctrine, insisted that the Catholic church was superior to all others. The pope has tried to soften it, thereby giving the lie to those who say he is in the hands of hardliners; but ithas not been repudiated.

In recent years there have been several apologies, including an astonishingly broad one by the pope in March 2000, for the persecution of other faiths by members of the church. The sharp-eyed noticed that there was no apology for the doctrines that justified those actions. Those who had suffered, or their descendants, thought the gesture half-hearted. Jews have generally found the pope both sympathetic and obtuse. Muslims have made small progress with him. The eastern Christian churches have felt offended, with reason, at the attempts of Rome to proselytise in Russia, a particular crusade of this Polish pope. Some Hindus have been appalled by the pope’s open call, on Indian soil, for conversions in Asia. Although he has gained much credit for being conciliatory, Pope John Paul cannot be a pluralist any more than he can be a democrat.

Apostolic successors

The church is now waiting, sometimes with ill-disguised impatience, for Pope John Paul to go. He is frail and shaky with Parkinson’s disease, and no longer manages much church business; but a pope has not willingly retired since the 13th century. In any case, is his successor likely to think differently? That depends on whether the progressive tendency or the conservative gets the upper hand in Rome.

Vatican-watchers are reluctant to name names, and the names in any case change constantly, as the gossip does. The received wisdom is that the college of cardinals would prefer an old pope (no risk of another long reign, in which one man imposes his personality too strongly on the church) and an Italian (back to what they know, after the worrying crusader-mentality of a Pole). The pope’s new batch of 37 cardinals, named on January 21st, confirms this thinking. Fully 112 members of the college have now been appointed by him, and presumably share his thinking to a large degree. Nine of the new cardinals come from the Curia, the conservative core. Yet this brings only to 20 or so the number of voting cardinals with a curial background. The rest, who include a block of 26 Latin American cardinals (ten newly named), are freer agents.

EPA

The men who must decide

If pushed to choose among the red-hats, Vatican-watchers most often come up with Carlo Maria Martini of Milan, a 73-year-old Jesuit “liberal” (insofar as cardinals are ever that), who favours a new council and has dared to suggest that papal authority needs rethinking. A less provocative choice is Dionigi Tettamanzi of Genoa, a popular moderate with a sense of humour and, at 66, a youngster. The secular press, fancying a black pope, tips Francis Arinze of Nigeria. His election would probably be a statement too far for most cardinals.

The most that is hoped for in the next pope is that he might acknowledge the difficulties the church is facing, consult the bishops more, and soften some of the language. (It may help that Cardinal Ratzinger, who is credited or debited with much of the Vatican’s harshest behaviour, has no desire to be kept on.) Yet the next pope could be strongly reformist if he were so inclined. He could, if he wanted, make the Curia a subordinate secretariat again. He could also convene, and nudge in a democratic direction, the synods in which the bishops and their superiors debate the teaching of the church. Simply because Pope John Paul has shown little interest in either does not mean that his successor will follow suit.

The challenge to the church is as clear as it has ever been. It has to prove its relevance to a world in which secularism is triumphant and misery is pervasive, bringing into question both God’s grace and Christ’s message. In certain places, often in response to the surge of evangelical Protestant groups, Catholicism has managed radically to recast itself. Many Catholic lay movements (which Pope John Paul

strongly supports) preserve a spirit of tireless social action.

John XXIII dreamed that this spirit might also permeate the institutional church. The years since Vatican II have often suggested that this dream was unrealistic, but not always. The secularisation of society has in some ways freed the church. It has long ceased to sit at the centre of the West's world view, and now lingers somewhere at the edge of it: no longer an authority for an obedient flock, but a sniper and interrupter. Politically, it is powerless; no territory beyond the Vatican, and few of the ties to right-wing regimes and parties that it had until recently in both Europe and Latin America.

Yet with no stake in preserving the political status quo, the church should be able to speak out as a radical voice. And it still has a startling message for humanity to consider, if it can gather again the respect and the manpower to promote it: the message that God is love, and that it is by love of God and neighbour that mankind is saved.

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The education president (Part 2)

Jan 25th 2001 | WASHINGTON, DC
From The Economist print edition

George Bush wants to improve America's schools. The usual dinosaurs will obstruct him

Get article background

THE 93% of Americans who don't live in Texas may already feel they have had enough of it. Yet Mr Bush's first legislative gambit as president comes straight out of his Texas handbook. Plant your standard firmly on Democratic turf. Cobble together a collection of ideas that have acquired a certain degree of legislative traction. Push through a compromise reform package with the help of prominent Democrats. And then noisily claim that it is one of the boldest pieces of legislation in history.

On January 23rd Mr Bush brought this play to Washington. He delivered a surprisingly fluent speech claiming that education is his first priority. He also met a bipartisan group of legislators who specialise in education, went to the Department of Education to watch his education secretary, Rod Paige, being sworn in, dropped in on a couple of schools and held a conference with Republican governors.

Mr Bush proposes four basic reforms. First, subject all schoolchildren in the third through eighth grades (roughly 9-15) to annual tests, and publish reports on their progress. Second, make schools accountable for their performance. Third, remove federal regulations on schools and school districts in exchange for improved results. Fourth, let parents of children trapped in sink schools spend federal money in private or parochial schools. (The Bush people have banned the term "vouchers" as too explosive, but that is the idea.)

The essence of Mr Bush's programme, to advance accountability by establishing a few national standards while freeing states to experiment, is not as radical as some had hoped. The vouchers part is weedy, and Mr Bush has signalled that he is willing to drop it in any case. That is one reason why the initiative is likely to gain strong support. Bipartisanship is everywhere. The theme of Mr Bush's education bill, "Leave no child behind", echoes the decade-old motto of the leftish Children's Defence Fund. Ted Kennedy, the senior Democrat on the Senate Education Committee, talks about "overwhelming areas of agreement and support". Mr Bush mentioned three Democrats in his speech, George Miller, Jeff Bingaman and Joe Lieberman; he also promised a significant (though unspecified) expansion in federal funding for education to smooth the bill's way.

This bipartisanship is not just for the cameras. It is the result of a new consensus on education. There is growing agreement that the poor school performance of many minority and disadvantaged children is a national disgrace. There is a growing agreement that the war on educational inequality has failed: America has spent $120 billion trying to raise the achievements of poor children since 1965 without any appreciable closing of the education gap. And there is even a growing consensus that the federal government should trade bureaucratic control in return for better test results.

The right is reconciling itself to the federal government playing an active role in education. ("The federal role in education is here to stay," says a recent Heritage Foundation pamphlet flatly.) The left is reconciling itself to the importance of accountability and competition in improving educational results. This all adds up to a new consensus: that "conservative methods" (accountability and competition, in regulated doses) can achieve "liberal" goals (closing the gap between rich and poor children).

Perhaps the most convincing evidence of bipartisanship on this subject is that Mr Bush's old rival, Mr

Lieberman, introduced an education bill on exactly the same day as Mr Bush, and the president went out of his way to praise it. Mr Lieberman's bill sounds many of the same notes as Mr Bush's, consolidating the 50 current federal programmes into five broad categories, offering states far more flexibility in how they spend their money in return for hitting broad performance targets and including penalties for schools that fail to spend their money wisely (such as being turned into charter schools). Another bill introduced this week by moderate Republicans also has striking similarities to Mr Bush's bill, though without vouchers.

Several things make it likely that Mr Bush will be able to turn consensus into action. The first is that most lawmakers put education at the top of their list of priorities in the November elections. The second is that most politicians are desperate to get something done in order to dispel the idea that Washington is a dysfunctional town. The third is that Mr Paige, the former head of the Houston school district, is a widely popular choice to run the Department of Education. The fourth is that Mr Bush has the support of the Republican governors, who can act as a powerful counterweight to the education establishment.

This is not to say that it will all be plain sailing. The idea of giving parents vouchers to rescue their children from chronically underperforming schools is unlikely to survive, despite mounting evidence that school choice improves the educational chances of poor children (see Economics focus). Most Democrats, with their close ties to the teachers' unions, oppose the idea to the hilt. ("If he insists on vouchers," says Tom Daschle, the Democratic leader in the Senate, "you've got your first problem.") Mr Bush is unlikely to let vouchers sink the rest of his programme. During his confirmation hearings Mr Paige announced that vouchers will not be a priority for the new administration.

There is also a broader problem: American education is so decentralised. The federal government accounts for only about 7% of education spending; real power is dispersed among the country's 14,800 school districts. This raises the possibility that Mr Bush will nationalise the blame for educational failure without nationalising the means to eliminate that failure.

The decentralisation of American education also makes it impossible to introduce national testing standards. Tying federal funds to performance in tests sounds wonderful in theory. But what happens when every state can decide not only what tests to use but also what pass-mark to employ? At best, you end up with an extraordinarily complicated system. At worst, states could try to trick the system by employing inflated educational currency.

All that could cause problems in the future. But there is no doubt that Mr Bush's decision to focus on education is a sensible political move. It offers him the chance of pushing a bipartisan reform through fairly quickly. It underlines his claim to be a different kind of Republican—different from his father, who claimed to be "the education president", but preferred foreign policy, and different from Newt Gingrich, who put the abolition of the Department of Education at the heart of his reforms. And it burnishes his reputation for "bold incrementalism".

Eight years ago, Bill Clinton's administration started its term in office by focusing on a subject that polarised opinion across the country, gays in the armed forces. In choosing a subject that is at the top of the national agenda and ripe for bipartisan compromise, Mr Bush has got off to a dramatically better start. It is not certain whether he will be able to get that much further. But his focus, at least, is exactly right.

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Western lands

Monumental struggle

Jan 25th 2001
From The Economist print edition

The growing debate about the west reflects a division not just in the faster-growing half of America but also within the Republican Party

SURPRISINGLY little was said during the recent presidential race about the environment. Since George Bush's victory, however, the din has grown steadily louder. By picking Gale Norton, a conservative lawyer from Colorado, to be secretary of the interior, with responsibility for the management of much of America's public land, Mr Bush has provoked an outcry from environmentalists.

Ms Norton was finally confirmed on January 24th with a handsome margin, although her hearings had been the second-most-cantankerous after those for John Ashcroft, Mr Bush's nominee for attorney-general. As her critics kept repeating, Ms Norton spent much of her early career representing the interests of ranchers, miners and timber firms. Those folk gave large contributions to the Republicans last year, and now expect payback.

Mr Clinton used the dying days of his administration to make some environmental noise of his own. On January 5th he issued an executive order forbidding the building of roads on 58.5m acres of land run by the Forest Service—about a third of the total. Without roads, the forests, mostly in the west, will remain inaccessible to loggers and to firms prospecting for oil and gas. Other announcements included a ban on harvesting old-growth trees on public lands and the creation of seven new protected "national monuments", to add to the 14 Mr Clinton created or expanded in his time in office.

To some western Republicans, war has already been declared. Most public land is concentrated in the west—and, historically, natural resources have been the source of local prosperity. James Hansen, a Republican congressman from empty western Utah who will chair the House Resources Committee, has written to Mr Bush urging him to reverse the orders creating national monuments and protecting national forests. Mr Bush has taken his advice, suspending the creation of almost all Mr Clinton's national monuments as one of his first acts on taking office.

In fact, such a war to reconquer the west is hard to wage. The flurry of orders from Mr Clinton was not a last-minute idea, but the outcome of long legal processes that will take many months, perhaps years, to undo. An act of Congress could overturn the ban on road-building. But the Senate is evenly split, and nothing will get through easily.

Some Democrats would relish a battle over national monuments and forests, seeing it as a way to drain momentum from Mr Bush in his early weeks. Yet the battle over land use might be less between Democrats and Republicans than between different sorts of Republicans. Many eastern Republicans like Mr Clinton's greenery, and western Republicans themselves are divided. Some represent places, such as the suburbs of Denver, where people like to hike in the mountains rather than mine them. (The west's cities, in fact, are now growing faster than those anywhere else in the country.) Old-schoolers like Mr Hansen, who still subscribe to the romantic image of loggers and ranchers battling with nature, are increasingly balanced by pragmatists who recognise that the region's economy is diversifying. Mike Leavitt, the Republican governor of Utah, admits that the creation of the new Grand Staircase-Escalante national monument has upset the people who live close to it, but it draws in visitors and, therefore, brings economic benefits to his state.

Even Ms Norton has something of a split personality. She remains philosophically committed to the defence of property rights, which is the basis for conservative attacks on many environmental-protection laws. But as attorney-general in Colorado she helped to clean up mines and timber mills, and she stated during her confirmation hearings that she was "fully committed" to protecting national parks. Her critics are having to weigh that against her pledge to review "what needs to be changed" in Mr Clinton's flurry

of last-minute regulations.

Republicans prefer local control to government intervention, but this does not necessarily mean much of a change in policy. Under the Clinton administration there has been fast growth in groups such as the Grand Canyon Trust, which bring together different interests to resolve conflicts over land use without involving Washington. In fact, westerners' bark is often worse than their bite. The west kicked up a tremendous storm when President Carter embarked on a course of cutting federal subsidies to economically crazy water projects in the west, but quietly lived with the same policy when Presidents Reagan and Bush continued it.

On the other hand, the Clinton administration has persuaded warring groups to talk to each other partly by threatening strict enforcement of the laws. A secretary of the interior who took a lighter approach would not be so persuasive. Although federal money is an inducement, it tends to be allocated to a few big projects, such as Calfed (a huge collaboration between California and the federal government to manage the state's water supply) or the Everglades project in Florida. If laws can be winked at, industry and landowners will have little incentive to try to cut deals with tree-huggers. That might mean that environmentalists would return to their old tactics of the 1970s and 1980s, and take their battle to the courts instead.

Which strain of Republicanism will win the day? Ms Norton's confirmation hearings left the question unclear, but Mr Bush himself has been unequivocal. He intends to press on as quickly as possible to open part of the Arctic wildlife refuge to drilling. The refuge, 19m acres on the north coast of Alaska, chock-full of rare plants and animals, sits on top of a lot of oil. The state's powerful senators and the energy industry want to tap it, not least because they see it as a part-solution to the chronic power problems of California (see Lexington). Mr Bush proposes to open about 8% of it, or 1.5m acres. Mr Clinton assiduously threatened to veto any such invasion. Ms Norton has merely said she will "evaluate the environmental consequences" before the drilling starts.

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Rich friend of Bill

Jan 25th 2001 | NEW YORK
From The Economist print edition

HAVING lost the right to rent out a bedroom on Pennsylvania Avenue, Bill Clinton spent his last day in office distributing presidential gifts of an equally unique and pleasing nature. He pardoned more than 100 people, including Patty Hearst, the heiress who was kidnapped and robbed a bank in 1974; his old Whitewater associate, Susan McDougal; John Deutch, a former director of the CIA, who had mishandled secret information; Henry Cisneros, a former secretary of housing and urban development, who had mishandled payments to his mistress; and his half-brother Roger, who had mishandled cocaine in many parts of Arkansas.

The names that drew most attention, however, were those of a dozen people prosecuted by the US attorney in the Southern District in New York, which includes Wall Street. Because, much to its disgust, the office was not consulted, details of many of these cases are still to be unearthed from the archives. But the most controversial is the pardon of Marc Rich and his partner Pincus Green.

Mr Rich has never come to trial; he pre-empted the process by fleeing to Switzerland in 1983. According to a lengthy and thorough indictment prepared by the then US attorney for the Southern District, Rudolph Giuliani (now New York's mayor), Mr Rich was guilty of four distinctly different but inter-related crimes. First, during the late 1970s and early 1980s—when the American embassy in Iran had been seized and world energy markets were a mess—Mr Rich imported millions of barrels of oil from Iran despite a trade embargo. He then orchestrated a complex series of trades, first to skirt existing American price controls on domestically produced oil and, second, to create phoney losses that offset $48m in potential taxes. In his most audacious move, he persuaded American banks to send over $200m to Iran for the oil purchases, breaking strict prohibitions in place at a time when America was, in a sense, at war.

Mr Rich has also been linked to efforts to circumvent trade sanctions imposed on South Africa, as well as to a successful cornering of the aluminium market. He lives in a shadowy world where truth is elusive; but matters may get clearer now that interest in his case has been revived by Mr Clinton's pardon.

Many efforts have been made to extradite Mr Rich to face charges. By itself, "trading with the enemy" could send him to jail for 80 years. Now he can fly home and, because he has renounced American citizenship, his fortune would seem to be immune from American taxes.

Why was he let off? Mr Rich's former wife, Denise Rich, is a big contributor to the Democratic Party in general and to Hillary Clinton in particular; his lawyer, Jack Quinn, is a former general counsel to Mr Clinton and was chief of staff to the former vice-president, Al Gore. Mr Giuliani criticised Mr Clinton's actions, saying Mr Rich had never paid his dues to society. Apparently there is more than one way to pay.

In contrast, Mr Giuliani urged a pardon to be granted to another man, one he successfully prosecuted, who actually served time in jail and paid restitution: Michael Milken. Mr Milken's crimes, which involved failure to disclose information and market manipulation, were not remotely on the scale of what has been alleged against Mr Rich—and Mr Milken's contributions to America, as a philanthropist and through his creation of the junk-bond market, have been infinitely greater. Yet he was not pardoned. The reasons why are unclear; the only certainty in these cases is that justice was not blind.

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Manufacturing

Not making it

Jan 25th 2001 | NEW YORK
From The Economist print edition

WHETHER the entire American economy is now in recession is still debatable, but nobody doubts that manufacturing is in the grip of a severe downturn. Will the rest of the economy go down with it?

Every day brings reports of more well-known firms cutting jobs. Manufacturing production fell at an annualised rate of 2.1% in the fourth quarter of 2000 compared with the third quarter—the biggest decline since the recession a decade ago. Two leading indicators of manufacturing activity have both plunged in recent months (see chart). The National Association of Purchasing Managers' index has fallen to a level that, in the past, has occurred only when the economy as a whole has gone into recession.

There are several sources of manufacturing's troubles. Despite its recent slide against the euro, the dollar remains strong relative to the currencies of its trading partners as a group. This has raised the price of American exports. Slower export growth has hit profits, as have rising labour costs, in turn causing firms to cut back on growth plans. This hurts suppliers and capital-goods producers.

Many companies became over-optimistic as, a year ago, the boom went roaring on, and increased production at precisely the wrong time, building up large inventories which they are now desperate to trim. Moreover, many manufacturing firms have never fully recovered from the Asian economic crisis of a few years ago. The result has been a dramatic fall in confidence in the manufacturing sector, starting last autumn, with reports of mass abandonment of plans to increase investment this year.

A recession in manufacturing does not always coincide with recession in the broader economy. Manufacturing's share of GDP is a mere 16%, its share of employment 15%. It is dwarfed by consumer spending—though, because of its unprecedented scale, corporate investment has been a vital contributor to total economic growth in the past few years. Manufacturing firms also create demand elsewhere in the economy, directly through their own purchase of services and indirectly through the private spending of their employees.

A downturn in manufacturing also affects the American psyche. People in other sectors may start to feel insecure about their own jobs and rein in their spending, just in case. Yet manufacturing's problems may also be reflecting developments in the broader economy, as much as leading them. For instance, the industry that has been hardest hit is car production, in which output in the fourth quarter of 2000 was 12.1% lower than a year earlier. A sharp fall in car buying may suggest that consumers are cutting down their spending across the board.

One mystery is why, despite the recession in manufacturing and the slowdown in the rest of the economy, unemployment has stayed so low. Consumer spending is unlikely to plunge to recessionary levels while there is, in effect, full employment.

Reports of job cuts in manufacturing may mean that the unemployment rate will soon start to rise. On the other hand, it seems that many firms are hoarding labour. Having found it increasingly difficult to hire skilled workers in recent years, they are loth to let them go now and risk being caught short again if the economy proves stronger than expected. Other firms are taking advantage of layoffs elsewhere to

plug gaps in their workforce. As a result, points out Ian Shepherdson of High Frequency Economics, the pain of economic slowdown may be felt first in productivity, and only later in job cuts.

This makes life much harder for Alan Greenspan, chairman of the Federal Reserve. He faces a schizophrenic economy: on the one hand, full employment, rising wages and still healthy (if falling) consumer confidence; on the other, a collapse of confidence in the country's boardrooms. His recent behaviour, in the opinion of Bruce Kasman of J.P. Morgan Chase, suggests it is business sentiment that concerns him most, and that he will do all he can to arrest its decline, whatever the longer-term risks may be for the economy. This is the likeliest explanation for the shock half-point cut in interest rates he announced on January 3rd.

Can the Fed's great Houdini pull off another great escape? Aggressive rate-cutting quickly revived the economy in 1995; but, despite being twice as large, his series of rate cuts in 1989 did not prevent the economy slipping into recession. From the muted reaction to the recent rate cut, it is clear that things will not be so easy now as in 1995, says Mr Kasman. But then no escape-artist likes his stunts to look easy.

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Correction

Jan 25th 2001
From The Economist print edition

Correction: Our map of the election results by state last week erroneously showed Oregon in the Bush column. It went to Al Gore. Our apologies for rubbing salt in the wounds.

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Abortion politics

Trench warfare

Jan 25th 2001 | WASHINGTON, DC
From The Economist print edition

DURING Europe's wars of religion, armies used to go into battle singing psalms. Five centuries later, a polite group of elderly right-to-lifers from New Jersey stride down Constitution Avenue quietly intoning the Hail Mary. One clutches a crucifix; another is pushed in a wheelchair. A politician poses for his picture with a man in a George Bush mask holding a sign proclaiming, "It's war, baby."

Every January anti-abortion marchers mark the anniversary of *Roe v Wade*, the 1973 decision by the Supreme Court that allows legal abortion. This year, with Mr Bush in the White House, they felt that the war might be edging their way—a view apparently shared by abortion-rights activists, who marked the anniversary with a pessimistic vigil of their own. In fact, any gain or loss of territory will probably be marginal.

Mr Bush cheered the protesters by issuing an executive order to block the use of federal money to pay for abortions overseas. This restored the so-called "Mexico city policy" that Bill Clinton overturned exactly eight years ago. The announcement was neither unexpected (a decision had to be made by February) nor particularly harsh in its impact. Despite some howling from feminists, America will still allow money to be spent by aid agencies overseas on other forms of family planning, such as contraception advice. In many parts of the developing world abortions are illegal anyway.

During the campaign, Mr Bush pledged his personal loyalty to the anti-abortion cause while making frantic hand signals to moderate voters that he would do little to overturn *Roe v Wade*: two-thirds of Americans think abortion should stay legal. His nomination of John Ashcroft for the post of attorney-general has terrified some abortion-rights people, but there is relatively little that even that ultra-conservative former senator can do to stop abortions without changing the constitution. And Mr Bush's legislative priorities are firmly elsewhere.

That said, battle is bound to be rejoined sooner or later on three fronts. First, Congress may eventually pass a bill banning "partial birth", or late-term, abortions. Mr Clinton vetoed two such efforts, but Mr Bush would sign it into law. Women's groups oppose such a ban on principle, but voters are more squeamish about the gruesome procedure. The political impact may depend on the exceptions and terms of the bill.

Second, there is the Supreme Court. Mr Bush has waffled about nominating only judges who would stick to a strict interpretation of the constitution. This cleverly reassured moderate voters that abortion would not be a litmus test, but also sent a coded message of hope to anti-abortion folk, who regard *Roe v Wade* as a classic case of judicial overreach.

Finally, bubbling slowly to the surface, is the awkward issue of biotechnology. Some anti-abortion groups have squawked about Mr Bush's nomination of Tommy Thompson as his health secretary. The governor of Wisconsin opposes abortion and has said he will review the safety of RU-486, the recently approved abortion pill; but, like many other business-minded Republicans, he appears to support the creation and use of embryos for stem-cell research. Such genetic tampering enrages not just church groups but also more leftish anti-corporate figures. The abortion war, like its military equivalent, is not only going high-tech; it is also becoming harder to tell who is fighting whom.

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Jesse Jackson

Closing ranks

Jan 25th 2001 | CHICAGO
From The Economist print edition

AS PENANCES go, it was one of the shorter ones. On January 18th, the Rev Jesse Jackson publicly announced that he had fathered a child, now 20 months old, as the result of an affair with a former staff member. He asked for forgiveness and said that he would temporarily withdraw from public life, in order to revive his spirit and reconnect with his family. Four days later, Mr Jackson addressed 200 ministers and public officials in Chicago, railing against the immoral "Confederate agenda" of the fledgling Bush administration. His listeners stood and shouted, "We love Jesse Jackson."

Reuters

Just you keep looking sorry

What price will Jesse pay for his misdeeds? After all the usual hand-wringing over powerful men being led astray by their urges (no wonder Mr Jackson could offer such sympathy to President Clinton, who was receiving counselling from him about Monica at just the time the Reverend was romping), blacks have closed ranks around their leader. Board members of the Rainbow/PUSH Coalition, the civil-rights organisation Mr Jackson founded, offered him a unanimous vote of confidence and urged him to stay on as president.

Indeed, those who have offered more than a slap on the wrist have found themselves shouted down. Mary Mitchell, a black columnist for the *Chicago Sun-Times*, castigated Mr Jackson in her column as a bad role-model at a time when illegitimacy and HIV/AIDS are scourges in the black community. Her reward was a flood of angry e-mails and phone calls from readers who thought her role was "to defend black leaders no matter what they've done".

Many observers believe that Mr Jackson's admission will not hurt him politically in the long term. By admitting the affair, he won points for candour, and he has promised to pay child support. Most important, Mr Jackson's timing is impeccable, says David Bositis, a senior political analyst at the Joint Centre for Political and Economic Studies, a black think-tank in Washington. He is a master of political opposition at a time when the Bush administration will provide many new things to oppose. The Democrats have also learned from Bill Clinton and Al Gore that charisma matters more than moral rectitude; and Mr Jackson, according to Clarence Page of the *Chicago Tribune*, has more rock-star appeal than any civil-rights leader since Martin Luther King.

But the rock star may have been growing tone-deaf long before his embarrassing revelation, says Mr Page, who has followed Mr Jackson's political career for 30 years. He did not earn much gratitude for intervening on behalf of six black students expelled from a Decatur, Illinois, high school for brawling at a football match. He also lost credibility last summer by claiming that a black Mississippi boy had been lynched for dating white girls, when forensic experts concluded that the boy had committed suicide.

Meanwhile, Ralph Nader replaced Mr Jackson in the 2000 election as the voice of the left. Even in post-election Florida, where there was reasonable evidence that black voters were disenfranchised, Mr Jackson struggled for media attention. When he claimed that the final result was invalid, his tone was too strident even for many Democrats. These events, and an unwillingness to stand for any elected office that he might actually win, have, says Mr Page, reinforced Mr Jackson's image as a political gadfly.

His success will ultimately be measured by his ability to draw other liberal constituencies, such as organised labour, under his umbrella. He must also continue his efforts to squeeze money and social change out of corporate America. This week, he will meet New York business leaders as part of his campaign to create more Wall Street jobs for blacks. With no elected power, he must depend on moral stature and the bully pulpit. "I think he gets knocked down a couple of pegs," says Paul Green, a

professor at Roosevelt University in Chicago.

Knocked down, perhaps, but not out. No other black leader has been as successful at building a national power base from a local following. “There isn’t a name that comes to mind—not Sharpton, not anybody,” says Alden Loury of the *Chicago Reporter*, who has written extensively on race. That may be the bigger issue lurking among the salacious details of Mr Jackson’s behaviour. It is probably time to make room at the podium for a new generation of black leaders. Where are they?

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Lexington

Gray Davis's perfect storm

Jan 25th 2001
From The Economist print edition

HOW many governors of California does it take to change a light bulb? Three. The first to turn off all the lights in the state. The second to stamp around in the dark yelling that it's not his fault. And a third to switch the lights back on. Gray Davis, the current governor, has so far been the second. He had better become the third quickly, or someone else will.

Mr Davis is the perfect politician facing the perfect storm. He has got to the position he is in—the only Democrat in charge of a large state and the dominant politician in the largest state in the country—by embodying the twin characteristics of modern American politics: raising money and not offending anyone.

As a fundraiser, he is prodigious, easily in the Clinton or Bush class. His war chest of around $30m is the largest assembled by anyone not running for national office. Paradoxically, he won the governorship of California despite being heavily outspent in what was, at the time, the most expensive statewide race ever. But like the Bavarian conservative leader of the 1970s who swore that so long as he was in politics, no one would ever run to his right, so Mr Davis concluded that he would never be outspent again. Thanks to the collapse of the California Republican Party, he has been able to arrange this, not only mopping up the funds that usually go to Democrats, but also—by acting as the main moderating influence on left-wingers in the state legislature—receiving contributions from grateful Republicans.

Mr Davis is a state-of-the-art moderate. He has sworn that taxes in California will never be raised on his watch, and seems to have made it an article of faith never to upset voters with policy surprises or big spending programmes. As a reader of public sentiment he is again in Bill Clinton's league, except that he is also a decorated Vietnam veteran of unimpeachable probity. In his first year as governor he claimed to be the only official with a mandate to set a policy agenda (a pretension that has now been abandoned). No wonder he is one of a handful of Democrats who could run for the presidency in 2004. Self-disciplined, poll-driven and ultra-cautious, Mr Davis is, in the words of Harold Meyerson of *LA Weekly*, "the minimalist governor": the very model of the modern centrist Democrat.

This is the man caught in the perfect storm. California's electricity debacle comes from the confluence of unexpectedly strong demand, supply hiccoughs, unusual weather patterns, price gouging and, above all, an unbelievably bungled "deregulation" in 1996 which freed the wholesale electricity market but imposed price controls at the retail level. Californians are rightly amazed that the world's most advanced economy can be suffering from third-world blackouts, with traffic lights switching off at rush hour and children getting stuck in lifts. This is one of the worst crises ever to hit the Golden State—and, unlike many of the disasters that have visited it, it is almost entirely man-made.

Mr Davis has responded with his preferred methods of incremental change. For months, he refused to listen to the mounting cries of alarm. He then permitted a minimal rate increase (10% for 90 days) and swore there would be no further price rises. He criticised the electricity generators as "out-of-state profiteers", said the whole mess was someone else's fault (which is correct: it was his predecessor's), and ducked any question of a taxpayer-financed bail-out of the utility companies. He then set aside $400m to buy electricity supplies, which will hardly last two weeks.

It is true that he is under pressure from some of the most vocal consumer and environmental lobby groups in the world: they have the power of the referendum to wield against him in a state with an

unusually volatile electorate. He also deserves some credit for backing the construction of new generating plants, the first in California for a decade, and for sending the state government out into the market to negotiate long-term contracts to flatten out the spike in wholesale prices. But these measures are relatively uncontroversial. Nearly everyone accepts that the long-term solution is for the state to produce more electricity and use longer-term contracts. The problem is how to get there and how to deal with the transition costs—and on this he has not only said almost nothing, but what little he has said may have made matters worse.

The simple fact is that for the past few months, Californian utilities have been forced to buy high and sell low (buying at wholesale prices, selling at fixed retail ones). Naturally, they have racked up vast debts: almost $12 billion. There is no way round the plain mathematics. Someone has to let them off selling at a loss. And someone has to pay their debt, or let them make a profit so they can do so. And the only "someone" who can do both is the Californian consumer. The utilities cannot afford it and there is no justification for the federal government to bail out the richest state in the nation. By refusing to countenance price rises or to offer a bail-out at the start, Mr Davis not only postponed the solution to the problem (however it is dressed up), but further undermined the teetering finances of the utility companies. It was his first crisis, and he flunked it.

Mr Davis has time to set matters right—though not much, since energy demand soars in the Californian summer, and Republicans are likely to take advantage of the crisis to regroup. If he succeeds, and wins re-election as governor in 2002, he would be in a position to campaign for the presidency in 2004 as the man who had solved the country's worst energy problem.

But his first reactions have been dismaying. Had he made a simple mistake, that would have been one thing. But his strategy so far has been rooted in those principles of cautious incrementalism and avoiding giving offence that have been his hallmark.

Gray Davis is a politician adept at controlling the ordinary variables. But the hardest challenges in politics, as Harold Macmillan, a British prime minister, once put it, come from "Events, dear boy, events". When a typhoon hit Mr Davis's boat, his navigational equipment stopped working. It is a lesson not only for California's governor but also for America's new president.

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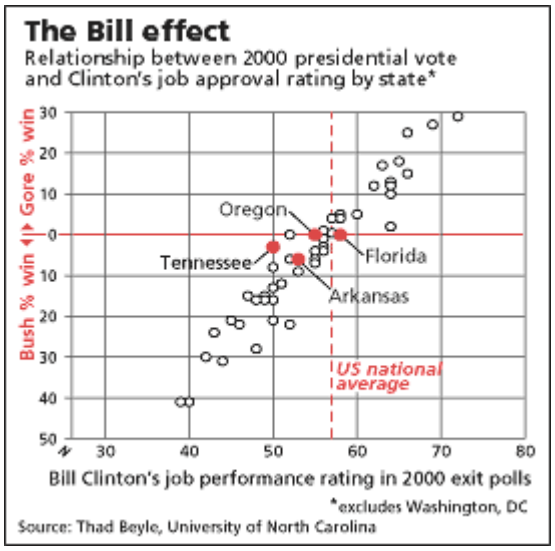
Al, it wasn't your fault

Jan 25th 2001 | CHAPEL HILL, NORTH CAROLINA
From The Economist print edition

THE notion that Al Gore mishandled Bill Clinton in the election campaign is entering Democratic lore. If only the most popular outgoing president in recent times had been allowed to go to his home state or Mr Gore's, he would have tipped Arkansas or Tennessee into the Democratic column and Mr Gore would have won. Or so everyone thinks. This chart, prepared by Thad Beyle of the University of North Carolina, Chapel Hill, explains why they are wrong.



It breaks Mr Clinton's popularity down state by state. And it shows there is an almost perfect match between that and the election result. With the exception of Florida (which was an exception to almost everything), Mr Gore won every state where Mr Clinton's favourability rating was average (ie, 57%) or above. Mr Bush won every state where Mr Clinton's popularity was a point or more below (with two exceptions, Oregon and New Mexico, both of which Mr Gore carried by less than 0.25% of the vote).

The chart suggests that Mr Clinton would almost certainly have made no difference in Arkansas or Tennessee, because his personal rating was too low in both states. The only place where he might possibly have helped Mr Gore was New Hampshire, where his rating was just one point below average. But Mr Gore could not take the risk. If Mr Clinton's appearance on the campaign trail had driven his overall ratings down by a point or two, Mr Gore would have lost by a landslide.

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Venezuela's revolution reaches the classroom

Jan 25th 2001 | CARACAS
From The Economist print edition

Teachers accuse President Hugo Chavez's "Bolivarian" government of wanting to foist Cuban-style indoctrination on the country's schools

IN A sparse office on the 19th floor of the featureless tower block that houses the Venezuelan education ministry, a former guerrilla is planning a revolution. Thirty years ago, Carlos Lanz was in the mountains with a gun in his hand. Later, he spent seven years in jail for his part in the three-year kidnapping of an American businessman. Nowadays, he is one of several guerrilla veterans who work for the government of President Hugo Chavez. Mr Lanz is in charge of the National Educational Project (PEN). This plan for a radical shake-up of Venezuela's schools is supposed to ensure the "irreversibility" of Mr Chavez's "Bolivarian revolution", named in homage to the (Venezuelan-born) South American independence leader of the early 19th century.

AP

A middle-class counter-revolution

Much of what Mr Lanz says about education reform sounds reasonable. Venezuela used to score well on education, compared with its neighbours. It still spends a lot on it, though much of that goes to public universities. Meanwhile, one child in ten fails to complete primary school, and almost one in five does not finish secondary education.

Drawn up after what the government claims was much consultation, the latest draft of the PEN calls for measures ranging from flexible curriculums to revamped teacher training, "debureaucratisation" and new school buildings. But the teachers' unions, private schools' associations and the church are fuming. They claim the government's not-so-hidden agenda is a Cuban-style indoctrination of youth. Their message, in a campaign of protest launched this month, is "Don't mess around with our kids". They have handed the National Assembly a counter-proposal for a new education law.

Mr Lanz says he is still a Marxist, although he also cites other ideological influences, such as Simon Rodriguez, a pioneer of universal education in Latin America who was Bolivar's own teacher. He says he has no time for the educational dogma of Fidel Castro's regime in Cuba, and wants to inculcate "critical consciousness" rather than blind adhesion to "Bolivarian" doctrine. But he admits that his agenda is political. The draft plan rails, for example, against the evils of globalisation and privatisation.

It is not hard to find evidence of a desire to indoctrinate. After he became president in 1999, Mr Chavez, a former army officer whose parents were both teachers, ordered the setting up of "Bolivarian schools", aimed at providing basic education and three meals a day for poor children. The armed forces run some of these schools. A new constitution obliges schools to teach "Bolivarian principles". "Pre-military" instruction is now compulsory for secondary students.

Bolivar is Venezuela's national hero, and his "principles" were in fact a loose bundle of radical republican notions and aristocratic, conservative paternalism. But Mr Chavez's political movement has appropriated Bolivar's name, on which it has hung its own leftist and populist nationalism.

Textbooks apparently endorsed by the education ministry have begun to reflect the government's new version of history. In exchange for cheap oil, Cuba has offered to provide teacher-trainers and educational materials. The education ministry has approved an essay competition on the theme of Che Guevara as an example to youth.

But what has pushed teachers and school officials to take action is a threat to their own jobs. In October, the government issued Decree 1,011, which creates a new echelon of senior school-inspectors appointed directly by the education minister and armed with wide powers to recommend dismissals. The teachers' unions call them political commissars—enforcers of the profession's ideological purity. They claim, too,

that a proposal to involve local communities, not just parents, in running schools is a scheme for political control.

“At no point were we consulted on the National Educational Project,” says Jaime Manzo, of the teachers’ federation. Only now, he argues, have his members “put the jigsaw puzzle together” and realised what the government is up to. Private schools are alarmed, too. Last month, Mr Chavez said that he was “declaring war on the immorality that continues to take place in private education.” The government insists that it has no quarrel with the principle of private schools. But Mr Chavez and his education minister, Hector Navarro, claim that some of them are simply businesses, with no educational ethic.

Rhetoric and reality

Mr Chavez’s fierce rhetoric often turns into more reasonable reality: he has centralised power in his own hands, but his regime is neither repressive nor competent at enforcing its own laws. And in education Cuba is in some ways an excellent model: international tests show that its children are the best-schooled in Latin America, even if they are not encouraged to think for themselves on politics. But neither do the government’s plans seem likely to improve education much.

The teachers’ federation has asked the Supreme Court to rule on the constitutionality of Decree 1,011. Mr Manzo, however, says that he has no faith in the court, which he sees as a tool of the executive. The teachers are exhausting all legal recourses within Venezuela, so as to be able to appeal to international organisations. “We don’t want to make the mistake they made in Cuba,” says Mr Manzo. “They didn’t react in time.”

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Brazil

Defence dilemmas

Jan 25th 2001 | SAO PAULO
From The Economist print edition

For the first time, civilian politicians are trying to think about what sort of armed forces Brazil needs

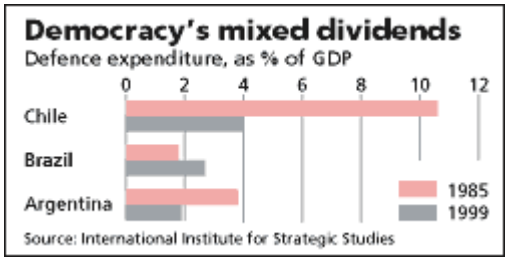
CHANGE sometimes comes slowly in Brazil. In 1995, a decade after the end of military dictatorship, President Fernando Henrique Cardoso proposed completing the transition to democracy by kicking the army, navy and air-force chiefs out of his cabinet and replacing them with a unified, civilian-run, defence ministry. Most other Latin American countries had already done this; it was not until 1999 that Mr Cardoso achieved it. With civilian control has come an effort to think more clearly about defence policy.

AP

Neighbours, beware

Geraldo Quintao, the defence minister, last year launched a defence review—an exercise routine in rich democracies, but almost unprecedented in Latin America. In Brazil's case, it is overdue. Though elsewhere in the region democracy has brought a sharp cut in defence spending, in Brazil such spending has increased (see chart).

In 1999, Brazil spent about $16 billion on defence—more than the rest of South America combined. But with the exception of Sivam, an ambitious and still uncompleted $1.4 billion project to monitor the Amazon basin using radars, early-warning aircraft and ground sensors, most spending has been on running costs, rather than replacing the forces' clapped-out equipment. That is now starting to change, with a $3.4 billion, eight-year programme to re-equip the air force.



The aim of the review is to try to align Brazil's military capabilities with its foreign-policy objectives. For much of the 20th century, Brazil's armed forces spent their time as political arbiters, when they did not rule themselves, and planning for a war with Argentina, which fortunately never happened. Now, Argentina is Brazil's principal economic and political partner in Mercosur. And as Brazil's economy and its democracy grow stronger, Mr Cardoso is quietly pressing his country's claims to be a regional leader.

With the exception of a small force sent to help the Allies in the second world war, Brazil has not waged a conventional war for 130 years. The review will probably recommend that it should stop planning for one. Instead, the armed forces should be ready to stop neighbours' civil conflicts (such as the fight between government and guerrillas in Colombia) from crossing its frontiers. They should be able to undertake regional peacekeeping (Brazil brokered the settlement to a border dispute between Peru and Ecuador in 1998). They should contribute to United Nations missions, stand ready to combat cross-border drugs-trafficking, and assist with disaster relief.

Mr Cardoso has already offered to give Brazil's neighbours information gathered by Sivam (on drug-smugglers' aircraft, for instance), and said they might get help from Brazil in a crisis. The spending on the air force, for new and re-equipped fighters, transport aircraft and helicopters, fits the new strategy. But recent purchases of second-hand tanks from America and Belgium do not, and would have been unlikely to secure approval had the defence review been completed sooner. Neither does the purchase last year of the *Foch*, an elderly French aircraft-carrier (for only $12m, it is true, but refitting will cost much more).

The proposed new roles for the armed forces make sense. Already, the army has redeployed to the

north, away from the Argentine border. And Brazil now regularly consults its Mercosur partners on defence matters. But the review ought to raise some questions. Should the armed forces really start chasing drug-traffickers or would that encroach on the police's responsibility, thus infringing the constitution? And at what point does regional peacekeeping become meddling in other nations' affairs?

On the other hand, if Brazil is serious about regional leadership, why has it not responded to pleas for help by Colombia's government in its fight against guerrillas and drug-traffickers? Instead, Brazil has rejected Colombia's request to make use of Brazilian airstrips, because that would be "taking sides" in a neighbour's politics.

The answer, say Brazilian officials, is that the armed forces, more than the politicians, are uneasy about the United States' aid to Colombia. The armed forces are especially sensitive towards what they see as American designs on the Amazon. Welcome though the defence review is, it may not achieve a perfect match between foreign-policy ambition and military dispositions.

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Canada

Dodging downdrafts

Jan 25th 2001 | OTTAWA
From The Economist print edition

WHEN the United States' economy sneezes, so does Canada's—but usually about six months later. So nobody will watch Alan Greenspan's efforts to avoid a "hard landing" more closely than David Dodge, who on January 31st begins a seven-year term as governor of the Bank of Canada, the country's independent central bank.

Usually the bank's governors are drawn from its own ranks. Mr Dodge, who is 57, marks a break with tradition: he has worked as an economics professor, and has in turn held the top civil-service job in the employment-and-immigration, finance, and health departments. These jobs have brought him into close contact with Paul Martin, the finance minister. In 1995, he persuaded Mr Martin to make sharp cuts in spending which, along with a goods-and-services tax that Mr Dodge had helped to bring in under the previous Tory government, turned a budget deficit of C$42 billion in 1993 ($33 billion) into several years of fat surpluses.

Though he owes his new job to the support of Mr Martin and Jean Chrétien, the prime minister, Mr Dodge is likely to want to show his independence in monetary policy. When appointed last month, he stated his commitment to low inflation. Delivering this while trying to minimise the damage to Canada from any American recession will require a delicate sense of timing.

Canada's economy has been roaring for the past few years, helped by the boom in the United States, which takes 86% of its exports and provides much of its inward investment. Canada's GDP grew by 5% in 2000, and the unemployment rate is at its lowest since the 1970s. But growth is forecast to fall this year to 2.5%. Already, sickness in Detroit's car industry has brought lay-offs north of the border. High energy prices, and the weaker American economy, could push the Canadian dollar up relative to the greenback, hurting exporters and the tourist industry, and strengthening the case for looser monetary policy.

But on the other hand, inflation, though lower than in the United States, rose to 3.2% in December. Stripping out seasonally high energy and food prices, "core" inflation, at 1.9%, was in the upper half of the band of 1-3% set by Mr Dodge's predecessors. And the economy has just had a fiscal stimulus. In October, on the eve of a federal election, Mr Martin announced big tax cuts, some of which came into effect this month.

No wonder that the Bank of Canada did not immediately match Mr Greenspan's surprise interest-rate cut of half a percentage point earlier this month. Instead, it waited until its regular meeting, on January 23rd, when it cautiously lowered Canada's benchmark rate from 6% to 5.75%. If Mr Dodge does match any future interest-rate cuts down south, it is likely to be only after a prudent lag. Perhaps it is as well that the new governor is a man of quick reaction and proven nerve: his hobbies include sea-kayaking and white-water rafting.

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Tar-footed boobies in the Galapagos

Jan 25th 2001 | QUITO
From The Economist print edition

FOR conservationists, the oil slick which this week spread out around the Galapagos Islands is a long-feared nightmare. For Ecuador's government, however, it is an unwelcome embarrassment—and one more warning of the increasing difficulty of reconciling conservation, tourism and the Pacific islands' growing population.

The disaster began on January 16th when the *Jessica*, a small and poorly-equipped Ecuadorean tanker loaded with 240,000 gallons of diesel and bunker fuel, ran into a well-known reef near San Cristobal, the most easterly of the islands.

Reuters

Even so, the spill could have been prevented. The ship was not holed until January 19th, and it took another two days for all the bunker fuel to leak into the sea. Technicians wrongly argued that the tanker could be refloated, delaying efforts to pump out the oil. Then Petroecuador, the state oil company, held matters up by trying to charge fishermen for oil they had unloaded from the stranded tanker. Local officials lacked equipment and training; a team from the United States' coastguard which specialises in unloading oil from wrecked tankers arrived only after much of it had leaked.

Fortunately, the weather came to the rescue. Winds and heavy tides broke most of the 185,000 gallons of spilt oil into small patches, and pushed it away from San Cristobal. By January 24th, only 12 sea lions, six turtles and some 50 seabirds (pelicans and blue-footed boobies) had been injured; four pelicans died. A "very preliminary" assessment suggests that the environmental impact of the spill may not be severe, according to Robert Bensted-Smith, the director of the Charles Darwin Research Station on the islands.

But the ecology of the Galapagos, home to many unique species of reptiles, birds and fish, is both intricate and fragile. It will be years before environmentalists know the full impact of the spill.

There are, though, some immediate lessons for the government. These include tightening safety regulations for ships entering the islands' waters, which were declared a marine reserve in 1998. Some 80 boats regularly ferry tourists round the Galapagos, requiring two tanker-loads of fuel per month. The islands, too, are home to growing numbers of fishermen. In November, after they staged violent demonstrations, the government backed down and increased lobster quotas.

Ecuador has many problems, including political instability, a recent economic slump and repercussions from Colombia's wars. Now it has the pollution in the Galapagos. Rodolfo Rendon, the environment minister, says that the government has "learnt a lot" from the *Jessica* disaster. Putting that into practice may be harder.

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Colombia

On the brink

Jan 25th 2001 | BOGOTA
From The Economist print edition

THE Colombian peace process may be troubled, but it is not yet dead. So suggested the manoeuvring this week between the government and Manuel Marulanda, the veteran leader of the FARC, the main guerrilla group. At issue is the future of a large “demilitarised” zone in the country’s southern jungles from which President Andres Pastrana withdrew troops in 1998 to get talks going.

Mr Pastrana must decide by January 31st whether to continue to tolerate the zone. With the talks frozen since November, when the FARC walked out, he is under pressure not to do so. As kidnappings and attacks have continued, public support for the peace process has plunged. But the deadline has at least prompted a flurry of talks about talks. The FARC has offered to release up to 100 of its 500 police and army captives, some of them in exchange for jailed guerrillas, others unilaterally.

But this week Mr Marulanda rejected the government’s call on the FARC to restart negotiations, and to stop its kidnappings and attacks on towns with gas-cylinder bombs. And once again, he insisted that Mr Pastrana should do more to rein in the country’s right-wing paramilitary groups.

The government claims to be doing its bit against the paramilitaries. But as if to drive it and the FARC further apart, right-wing militants have been on the rampage recently, killing some 170 civilians in 26 incidents this month. In Barrancabermeja, an oil town in central Colombia, the paramilitaries have been battling the ELN, the second guerrilla group. Their aim there is to prevent the creation of a second demilitarised zone, this one designed help start talks with the ELN.

The armed forces have never been enthusiastic about the demilitarised zone; officers say it has merely served as a haven to allow the rebels to recruit, rearm and tighten their hold on the local coca trade. Strengthened by American military aid, they claim to be ready to retake it. This week, in a well-publicised manoeuvre, they reinforced the troops stationed around the zone, bringing their number to over 3,000, and placed 7,000 more on alert.

In fact, the FARC has controlled most of the zone for four decades. Provided it now makes some sort of gesture, Mr Pastrana is likely to extend the life of the zone for a while longer. He has staked his presidency on the peace process. And for the time being nobody, except perhaps the paramilitaries, seems to want to abandon the prospect of eventual peace in favour of all-out war.

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About sponsorship

After the B movie, a new main attraction for Filipinos

Jan 25th 2001 | MANILA
From The Economist print edition

Corruption scandals have swept away the Philippines' president, and threaten Indonesia's. The Philippines first

HE DID not go willingly—or even, if looked at too closely, lawfully. But the fall of Joseph Estrada marks a new beginning for the Philippines, and the inclination of most of its citizens, as well as of most foreign governments, this week has been to breathe a sigh of relief and let the new president, Gloria Macapagal Arroyo, get on with the job. Investors celebrated in sympathy with the victorious protesters, lifting the peso and the stockmarket from the depths to which they had sunk under Mr Estrada's long ordeal. From capitals east and west, and most crucially from Washington, came congratulation and pledges of support.

AP

But will the masses adore Arroyo?

But Mrs Arroyo, an American-educated economist with years of experience in government, is shrewd enough to know that the celebrations will soon end. Before long, Filipinos will be arguing about what the latest upheaval was for. And although Mrs Arroyo was elected vice-president in 1998 with unprecedented support, the battle to unseat Mr Estrada has hurt her, in three ways.

First, she is now less trusted than ever by most poor Filipinos, who see her as having stolen power from their hero. Second, in helping to lead what its supporters have been quick to label "people power two" in a deliberate echo of the widely-based revolution that brought down Ferdinand Marcos in 1986, Mrs Arroyo has joined hands with an unwieldy coalition. The cast list ranges from businessmen who crave a period of stability to anti-establishment groups that will press for leftish reforms. Third, the new president inherits an economy that has been devastated by Mr Estrada's paralysis.

And then there is Mr Estrada himself, who stubbornly refuses to go away. Not that he has the option of leaving the country altogether: he and his immediate family have been banned from fleeing. But what is to become of him? Now that the impeachment hearings have become void, the country's ordinary prosecutors are promising to bring criminal charges against him. One such—that of plundering the economy—is potentially punishable by death. Mr Estrada meanwhile maintains that he has never properly resigned his post, and that he will challenge Mrs Arroyo's "temporary" presidency.

Quite how he plans to do so, however, is a bit of a mystery. The Supreme Court has unanimously handed the job to his successor, thus barring any hope of a legal challenge. The country's top generals have all abandoned him, making a bloodless counter-revolution impossible and a bloody one hard to imagine, despite unsubstantiated rumours. And although his supporters might attempt their own version of people power, the team that has just ousted him boasts all the popular heroes of the genre: the country's leading prelate, Cardinal Jaime Sin, along with ex-Presidents Corazon Aquino and Fidel Ramos. Those three have no counterparts on the ex-president's side.

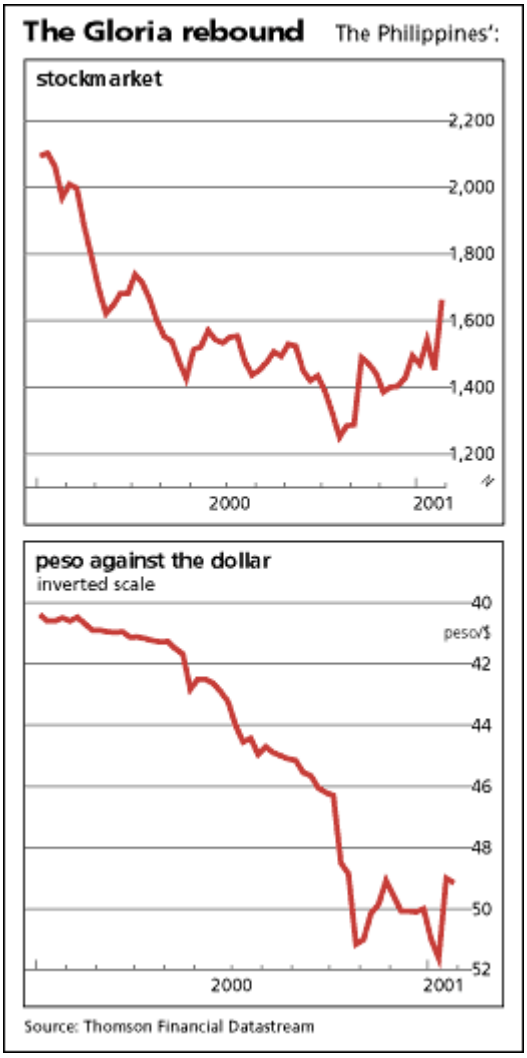
So while the Estrada saga continued this week—protesters gathered at a bank to prevent him from withdrawing $3m—Mrs Arroyo did her best to ignore it, devoting much of her early energy to short-term economic problems. The budget deficit was 136 billion pesos ($2.8 billion) in 2000, more than twice the government's target. The new government is warning of a 190 billion peso shortfall this year, including 70 billion pesos of additional expenses that went unpaid last year. And although the president enjoys extraordinary budgetary powers in the Philippines—including a line-item veto and the ability to

reallocate funds easily—most of the problem is on the other side of the ledger. The country's tax-collection system, notoriously porous to begin with, has sprung several new leaks in the past year.

The other immediate economic task will be to combat slowing growth. The Philippines could be hit hard by any slowdown in America, especially in the demand for electronics; and there are worries that 2001 will be a bad year for crops. One good way to offset these short-term problems would be to persuade investors that the long-term outlook has fundamentally changed with Mr Estrada's departure. Because Mrs Arroyo will be eligible for a full six-year term when this one ends, she could potentially be president for the next nine years.

She thus has a strong interest in promoting growth and sensible investment. The reforms that she is promising—to eliminate corruption, develop the country's regions and boost education—will not only raise its long-term economic prospects, but could also, slowly, begin to reduce the resentments that still fester among the poor.

They had backed Mr Estrada—a drunken, womanising, film star who was kicked out of high school for brawling—as their champion against the elites that have run the Philippines since its independence in 1946. Many continued to do so, despite all the evidence that he was corrupt. That speaks volumes about the yawning gap between the haves and the have-nots: while the richest families thrive, the poor living in Manila's slums are often buried—sometimes literally—in the rubbish that the system creates. A revolution that does not change this divide will hardly seem like people power to them.



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About sponsorship

Will Wahid be next?

Jan 25th 2001 | JAKARTA
From The Economist print edition

A report on alleged presidential corruption is due in Indonesia next week

HIS 15-month-old presidency may be fragile, but Abdurrahman Wahid still delights in taunting his enemies. On January 29th, a special parliamentary committee will report on two scandals that have plagued Mr Wahid since the middle of last year. The first involves the embezzlement of 35 billion rupiah ($3.7m) from a state agency; the second relates to $2m in “donations” from the sultan of Brunei. This week, after a long stand-off, Mr Wahid appeared before the 50 members of parliament who make up the committee and were eager to ask him some questions—but only to tell them that they had no business doing so.

There was no Javanese subtlety in Mr Wahid’s message. The 60-year-old Muslim cleric bluntly accused his inquisitors of mixing law and politics, questioned their authority to interrogate him, and essentially dared them to impeach him. Many of his adversaries are itching to do just that, and they have been further emboldened this week by events in the Philippines.

AP

The president...

In one way, Mr Wahid’s foes believe they will have an easier time than their Filipino counterparts. Whereas Joseph Estrada entered his battle with a majority in the Senate, and was able to use it to frustrate the formal procedure, Mr Wahid’s party commands only 10% of the seats in parliament, and many of the coalition members who originally backed him now regret their choice. Amien Rais, chairman of Indonesia’s highest legislative body, the People’s Consultative Assembly (MPR), has publicly asked forgiveness for foisting Mr Wahid on the country. If they can get the ball rolling, his opponents believe, they will have enough votes to topple Mr Wahid in a special impeachment session later this year, without any need for the legally dubious steps that have just been taken in Manila.

the sultan and... the masseur

However, the evidence against Mr Wahid so far—more may emerge next week—is much less damning than that against Mr Estrada. The Indonesian president flatly denies any involvement in a scandal at Bulog, the national food agency. It was discovered last May that the agency had transferred $3.7m to a Mr Suwondo (who, like many Indonesians, has only one name). Mr Suwondo, generally described as Mr Wahid’s personal masseur—though he also has business and political links with the president—then absconded with the cash. The deputy head of Bulog, Mr Sapuan, had approved the transfer. When the scandal broke, he claimed he had handed over the money because the masseur had told him Mr Wahid had asked for it. Supposedly, it was to be used as humanitarian aid for the province of Aceh, where a secessionist revolt is under way.

Mr Sapuan has said that the masseur promised him the top job at Bulog in exchange for the transfer. But one obvious argument in Mr Wahid’s favour has been apparent from the beginning: before the scandal broke, he had indeed appointed a new head of Bulog, and it was not Mr Sapuan. Mr Suwondo, and the others who had received payment, were eventually tracked down, and Mr Suwondo has been interrogated. Efforts to show that the president approved his actions will feature prominently in next week’s report.

The main facts of the other scandal are more firmly established: the president has already admitted to accepting $2m from the sultan of Brunei. He says that this (like the other sum in dispute) was to be used as humanitarian aid for Aceh. But there is no sign that the money actually arrived there, or that it is in

the keeping of any government agency supposed to deal with the province. Much will depend on where the money actually went, not least because Mr Wahid has already been accused for months of blurring the line between campaign finance and corruption, by lining his party's coffers with contributions from powerful tycoons. Mr Wahid has never deigned to be specific about what precisely he did with the sultan's money, so, at the least, he is guilty of a lack of the openness he is supposed to be trying to introduce.

In his efforts to head off impeachment hearings, Mr Wahid has shown little humility before parliament, further undermining Indonesians' efforts to make their leaders accountable. The president provoked a similar confrontation with parliament last year, when it tried to question him over the sacking of some coalition partners in his cabinet. Mr Wahid has consistently argued, with strong constitutional backing, that he is accountable only to the MPR, which appointed him, and which combines parliament with representatives from the regions and various social groups.

As a result, many parliamentarians pushed last year to transform the annual MPR session into a special session to impeach the president. But the support of his vice-president, Megawati Sukarnoputri, helped stave off such a challenge. Her party is the largest in both parliament and the MPR; and if she were to decide to bring down Mr Wahid, few believe he could survive. Whether she decides to do it will depend partly on the evidence in next week's report, and on how people react to it.

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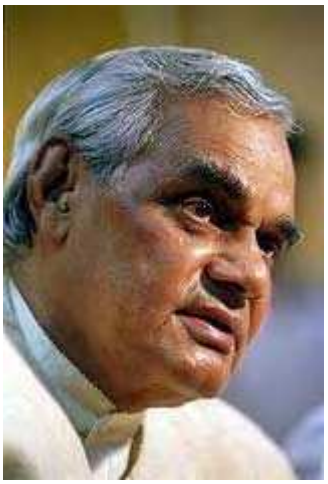
Kashmir

A missing visa

Jan 25th 2001 | DELHI
From The Economist print edition

Reuters



Vajpayee wants to talk

INDIA has received little thanks for suspending offensive operations against militants in the part of Kashmir it rules. Since the prime minister, Atal Behari Vajpayee, announced a unilateral ceasefire in late November, to coincide with the Muslim holy month of Ramadan, Pakistan-based militant groups have kept up their war, attacking an airport, buses and other targets. Government sources say they have used the lull in operations against them to rearm and to kill suspected informers. Nonetheless, India decided this week to extend by a further month the unrequited ceasefire, which was due to end on January 26th.

Its decision keeps alive hopes of talks between the government and the two groups most opposed to its rule: Kashmiri separatists, as represented by the All-Party Hurriyat Conference, and Pakistan, which has backed their cause. But a formula for starting formal negotiations with the Hurriyat has so far eluded India. A Hurriyat team was supposed to visit Pakistan in mid-January to get the blessing of its government and of militant groups for starting a peace process. But India has so far failed to issue passports to all five delegates the Hurriyat wants to send. India's main worry seems to be that Syed Ali Shah Geelani, a pro-Pakistan hardliner on the proposed delegation, will steal the show in Pakistan, pushing the moderates into the wings.

The Hurriyat is angry. Atrocities and harassment by security forces, mainly the ones controlled locally rather than by the central government, are rising after a respite, claims Yasin Malik, a Hurriyat leader who favours independence rather than union with Pakistan. Moderates in the Hurriyat want Mr Geelani to get his passport. They may not trust him, but they like even less the idea of the Indian government splitting the separatist coalition.

Rather than stalking out of the bazaar, the two sides are at least still haggling. Mr Malik and some other Hurriyat leaders have welcomed the extension of the ceasefire. Mr Vajpayee seems genuinely keen to talk to the moderates, though other members of his government may be less so. Both parties seem to agree that they cannot jettison hardliners like Mr Geelani, however little they like their views.

Without Pakistan's co-operation, though, talks between India and the Hurriyat will not get far. India had hoped that Pakistan would respond to its ceasefire by curbing militancy in the Muslim-majority state. That has not happened. Firing across the "line of control", the unofficial border that divides Kashmir into zones administered by India and by Pakistan, has diminished after a pull-back of Pakistani troops in December. But violence within Kashmir has remained high. According to official figures from the state, there were 467 incidents in the 55 days before the ceasefire and 456 during the same period afterwards. The number of "terrorists" and security forces killed has fallen, but the number of explosions, suicide attacks and civilians killed (including politicians and informers) is up. As it renewed the ceasefire India said that Pakistan "continues to promote, encourage and abet cross-border terrorism". It refuses to talk directly to Pakistan about Kashmir until it thinks that support has been curtailed. And India's recent test of its Agni II missile, capable of carrying nuclear warheads, may provoke a copycat test by Pakistan.

Pakistan's implacability stems from its fear that India's goal is to strike a deal with the Hurriyat, probably giving Kashmir autonomy within India, and force Pakistan to accept it. For peace, India must either convince Pakistan that its fear is unfounded or reconcile Pakistan to the consequences.

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Protests in Tiananmen Square

Jan 25th 2001
From The Economist print edition

IT TAKES a cult to know a cult, and the Chinese Communist Party is determined not to give an inch of Tiananmen Square to the Falun Gong, a spiritual movement that combines meditative exercises with a loony, millenarian outlook. Since its ban in mid-1999, there have been almost daily protests in the square, though few as dramatic as that on January 23rd, the eve of the Chinese new year, when five Falun Gong members doused themselves with petrol, and set themselves on fire. At least one woman died.

Reuters

Ready for anything

To an extent, the act seems to reinforce the point that endless propaganda has been making: that this is an evil cult whose leaders hoodwink ordinary people into harming themselves. The state has long claimed the movement causes suicides. More blame, however, probably attaches to the authorities: over 100 adherents may have died in police custody. Possibly hundreds of thousands have been detained, however briefly. The Falun Gong has decried the suicide attempts.

Tiananmen Square is the symbolic centre of power in China, which is why the two cults play out their rituals on it. In many other parts of China, the authorities crack down not just on the Falun Gong, but also on lesser known cults, as well as on Christian churches not approved by the state. In particular, the party is concerned to nip disparate sites of dissatisfaction in the bud before they blossom.

But in other parts of the country, the authorities recognise that provoking the Falun Gong merely increases its resistance. In Tianjin police appear to turn a blind eye to followers who meet in private. In Hong Kong, followers may protest in public. They cause the least harm to themselves, and even lend credit to Hong Kong's government.

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South Korea

A question of revenge

Jan 25th 2001 | SEOUL
From The Economist print edition

IN THE murky political history of South Korea two men in particular have been seen as heroes. After years of fighting misrule by military governments, in 1993 Kim Young Sam became president, the first directly elected civilian head of state for more than 30 years. In 1998, his former comrade, Kim Dae Jung, succeeded him as president in a peaceful transfer of power. Now Mr Kim Young Sam is suspected of being linked to a story of corruption while he was president.

AP

Jailbirds Roh and Chun

It is said that in 1996 some $80m of government money was funnelled to Mr Kim Young Sam's party, which distributed it to nearly 200 candidates campaigning in a parliamentary election. As well as being South Korea's president, Mr Kim was the chairman of the party.

Mr Kim has denied knowing of the misuse of any money. At the same time he has accused President Kim Dae Jung of seeking "political revenge". He has not specified what he means by revenge but Koreans are aware that the old comrades did fall out. In opposition they formed rival political parties. There were rumours of corruption during Mr Kim Young Sam's presidency, although only now has the state's prosecution agency come out with some detail. But Koreans also sigh that this may be another example of a president turning on his predecessor.

During Mr Kim Young Sam's presidency, two former presidents, Chun Doo Hwan and Roh Tae Woo, were jailed for treason, insurrection and taking bribes. The two men were freed in December 1997, just before Mr Kim's term of office ended. Other presidents had less peaceful exits. Syngman Rhee, who became South Korea's first head of state in 1948, was forced out and died in exile in Hawaii. The ensuing period of democracy ended when Park Chung Hee staged a military coup in 1961. He ruled for 18 years, but like Rhee he could not bring himself to give up power voluntarily and was assassinated by his intelligence chief. Some remember him only as a dictator, but he is given credit for transforming the poverty-stricken country into an economic power.

Each of South Korea's presidents has set out to outperform his predecessor. The economic prosperity of Chun's tenure created a middle class. Mr Roh pursued his "Nordpolitik", normalising relations with formerly hostile countries. Mr Kim Young Sam, too, can claim to be a reformer, ending the use of fictitious names in financial transactions, a change that has enabled the present government to probe the campaign-finance scandal.

Mr Roh is writing a memoir about his experience as president, although he is uncertain when he will publish it. South Korea needs a leader who is a man of "virtue, patience and forgiveness", he said in a written interview recently. How does President Kim Dae Jung measure up to these stern conditions? He has virtue. He was brave in the days of military rule, and has not been touched by stories of corruption. He has patience. He won the presidency at the fourth attempt. But forgiveness? Mr Kim Young Sam will hope that his accusation of "revenge" misjudges the president. Certainly, most Koreans would like an end to the vicious cycle of the incumbent turning on his predecessor.

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Central Asia

Nervous spring

Jan 25th 2001 | BISHKEK
From The Economist print edition

WITH spring not far off and with it the opening of Central Asia's snowy mountain passes, the region's leaders are growing nervous about expected attacks by Islamist militants from Tajikistan. The remote passes of south-west Kirgizstan are again likely to be the route militants take to Uzbekistan, whose government they aim to overthrow. Last year, 30 Kirgiz soldiers were killed trying to defend the passes, most by sniper fire.

There are reports that Juma Namangani, a leader of the radical Islamic Movement of Uzbekistan (IMU), has already crossed from his base in Afghanistan into Tajikistan with several hundred men, equipped with high-quality arms and supporting technology. The IMU, which also aims to set up an Islamic state in the Fergana valley, an area shared by Kirgizstan, Tajikistan and Uzbekistan, has been declared a terrorist organisation by the United States. It is said to have ties with Osama bin Laden, a Saudi living in Afghanistan who the Americans believe organised attacks on their embassies in Kenya and Tanzania in 1998. The IMU is also thought to have links with Afghanistan's drug traders.

Although the militants are at present relatively small in number, the armies of Central Asia are taking no chances. Kirgizstan's defence budget for this year has been almost tripled, though it is still only $16m, and President Askar Akaev told his defence council last week to be on the alert. Uzbekistan and Kazakhstan are also beefing up their armed forces. Uzbekistan has the largest and reportedly strongest army in Central Asia. But it was badly shaken by an IMU attack last summer. No figures have been officially announced, but at least 200 Uzbek soldiers were probably killed.

The presidents of Kazakhstan, Kirgizstan, Tajikistan and Uzbekistan met in Almaty, in Kazakhstan, on January 5th and agreed to co-operate against the growing threat. In the past, though, the four leaders have tended to pursue their own plans, in part out of necessity. "The authorities in Tajikistan do not control the whole territory," says Miroslav Niazov, deputy chairman of Kirgizstan's national security service. "That's why we are planning our own approach and taking preventive measures."

Uzbekistan, whose repressive ruler, Islam Karimov, has jailed thousands of opponents and driven more into exile, is secretly being blamed for the whole mess. The Kirgiz still grumble about Uzbekistan's accidental—or not so accidental, as some Kirgiz believe—dropping of bombs on a village in Kirgizstan during an IMU attack in 1999. Instead of hitting the rebels, the Uzbeks killed 12 villagers and damaged dozens of houses. Uzbekistan has upset Tajikistan by laying mines along the Uzbek-Tajik border. At least 20 Tajik civilians have been killed over the past few months, after wandering accidentally into the minefields.

Many Central Asians believe that the Islamist threat will end only when stability returns to Tajikistan and Afghanistan. Although Tajikistan's long civil war is over, the country remains divided, with some areas still not under government control. As for Afghanistan, the ruling Taliban are likely to be shunned as long as they continue to provide a base for groups like the IMU, never mind the repression of their own people.

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Malaysia

Good fellers

Jan 25th 2001
From The Economist print edition

LOGGING in South-East Asia is often a criminal affair. Illegal fellers have denuded much of Indonesia, and Myanmar's army, using slaves, is fast cutting down that country's tropical trees. In Cambodia and Laos, both rebels and soldiers have been felling trees for years, leaving land bare and vulnerable to erosion and flooding. In Vietnam, where the timber industry appears to be better controlled, illegal loggers nevertheless still flourish. And Thai monks have become so desperate to protect their country's few surviving trees that they wrap saffron robes on the trunks as a blessing.

Malaysia has long promoted itself as the big exception in the region. The government talks of "sustainable logging": chopping down only as many trees as can be felled without endangering the survival of its forests. Timber and furniture industries provide jobs, tax revenue and, for loggers, political influence. Last year the country produced 22m cubic metres of sawn logs, earning M$1.7 billion ($450m) from exports. It sells more tropical logs and sawn tropical timber abroad than any other country, and is one of the biggest exporters of hardwood. Domestic demand for wood, especially furniture, grew by 12% last year.

Yet all this means an annual net loss of perhaps 400,000 hectares (1,560 square miles) of trees, between 1% and 2% of Malaysia's forest cover, says the Food and Agriculture Organisation, though it admits exact measurements are hard to get. Even though a third of the country is covered by virgin or planted forest, the rate of felling is high—and not in the long term sustainable. Worse, in the eyes of western campaigners, Malaysia has refused to adopt international standards on managing forests. Greedy loggers in Malaysia are accused of ignoring the interests of indigenous people who live in the forests. In Sarawak, one of the largest timber-producing states, activists say locals have been displaced or even killed by loggers.

Forest nomads are losing their way of life, fish stocks have dwindled as topsoil has been washed into rivers, and wood is denied to those who want to build houses and boats, says Forests Monitor, an environmental group. It also says profits from timber help to fuel corruption as loggers help to finance local ruling parties, which in turn allocate areas to be felled. "Sarawak is a flashpoint of bad forest practice," says another observer of the timber industry.

Now, however, the national government seems ready to adopt standards set by the Forest Stewardship Council (FSC). These are used, mainly in Europe, Latin America and North America, to certify that timber comes from well-managed forests. In December the government and 200 representatives of indigenous and other groups agreed that the whole industry should be certified. That means giving a voice to local communities and ensuring that trees are planted as well as felled. Activists who came from Sarawak said they were surprised even to be allowed to attend the meeting (in the past their passports have been snatched and lawyers forbidden to meet them), let alone to reach an agreement.

So why has Malaysia's prickly prime minister, Mahathir Mohamad, ever a proud opponent of western values, agreed to a scheme devised by green groups such as the World Wide Fund for Nature (WWF), and the Tropical Forest Trust, which is financed by European furniture shops? He may have realised at last that being green pays well. Malaysia sells much wood in China and Japan, where buyers do not care about its history, but the most valuable markets are in the West. There, consumers want to believe their wood has not come to them at the expense of the environment and will pay as much as 50% more for certified stuff. That may mean as much as $1,000 for a cubic metre of tropical wood, says Steve Howard of WWF.

Forests Monitor is still sceptical that Sarawak, which has few trees left but large deposits of oil, will ever benefit. But for some Malaysian forests, such as one of 100,000 hectares in Sabah, which have already met FSC-standards, lucrative sales should be pending. Other states, take note.

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Another bad apple in Japan

Jan 25th 2001
From The Economist print edition

FORGET about policymaking. These days damage control is the sole concern of Japan's scandal-infested government. On January 23rd, Fukushiro Nukaga resigned as the minister in charge of economic and fiscal policy, to be replaced by Taro Aso, a former head of the Economic Planning Agency. Many see this as a step in the wrong direction as Mr Nukaga is considered more of a reformer than his replacement. Mr Nukaga, the third minister in six months to leave in disgrace, is alleged to have accepted ¥15m ($128,000) in donations from the KSD, an organisation representing small and medium-sized businesses across Japan, in return for promoting their interests, which included procuring public funds to help build a "craftsman's university" in Saitama.

Mr Nukaga is not the only politician in the ruling Liberal Democratic Party (LDP) to have lost his job over the affair. Masakuni Murakami, a party grandee, has already given up his job as leader of the LDP's upper-house members in penance for his close ties to the KSD; Takao Koyama, another LDP man, has been arrested for taking money in return for pushing legislation to help the group increase its profits. More suspects are likely to be named soon. All in all, it seems that the KSD, which has 1m members and earns some ¥25 billion in annual membership fees, has built up a wide bribery network over the years, involving non-politicians as well as LDP members.

The Japanese are also reeling from a recent discovery that a senior official skimmed several hundred million yen from the Foreign Ministry's "secret diplomacy" fund (used to pay, among other things, for the prime minister's trips abroad), which is unaudited, partly to buy and run a string of racehorses. Meanwhile, the country's prosecutors are still unravelling another complicated bribery scandal involving a former construction minister, a building company and a property developer who is said to have ties to Japan's biggest crime syndicate. Moreover, it is whispered that other party elders may also be implicated.

The gaffe-prone prime minister, Yoshiro Mori, has also lost two other ministers, one in charge of financial affairs and the other the chief cabinet secretary, to bribery and sex scandals. He himself has shown remarkable tenacity in keeping his own job in the face of all the scandals of his ten-month term in office, in some of which he himself has been involved. But with elections for the the upper house of the Diet coming up in July, many LDP elders are probably thinking it is time for Mr Mori to go. The prime minister's former chief minder, Hiromu Nonaka (who has himself now left Mr Mori's side), recently saw off Koichi Kato, the only real challenger for the top job. But with a third minister gone, it becomes ever more uncertain how long Mr Mori can postpone the day when he too must depart.

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Divorce after all these years? Not quite, but...

Jan 25th 2001 | BERLIN AND PARIS
From The Economist print edition

For decades, the Franco-German alliance, though often strained, has driven the development of what is now the European Union. The relationship is now under more strain than ever

LAST month's ill-tempered European Union summit in Nice brought Franco-German relations to a new low. Now Chancellor Gerhard Schröder has called for a "redefinition" of the partnership that has driven the construction of Europe. A threat or an olive branch? The French, suspicious of German intentions in a wider Europe, are not sure. They hope to learn when Mr Schröder and President Jacques Chirac meet in Strasbourg on January 31st. Mr Chirac, who set the meeting up, has already had a shock.

To the French, this was to be a public-relations exercise, an informal dinner to smooth things over after Nice. Mr Schröder intends something much weightier: a real discussion. Worse, he sees his redefinition in the context of his call last week for "bold" new steps in European integration.

The rival ideas of the EU's future have been shown up in two speeches. France's foreign minister, Hubert Védrine, in Berlin last week, praised the pragmatism of Nice. Unlike the Amsterdam treaty of 1997, which failed to resolve issues of institutional reform, he argued, the Nice agreement redistributes voting powers, restricts vetoes, reforms the European Commission and allows closer co-operation between countries that want to move faster than the rest. All today's 15 EU countries could accept it, new members too: in sum, no grand vision but "by definition, a compromise, but one that is democratic and positive".

A vision, however, is just what the Germans want. While Mr Védrine was preaching pragmatism, Mr Schröder was calling for an EU constitution; a notion backed by the commission, a body whose president was treated almost with disdain at Nice—and which is now ostentatiously backed by Mr Schröder. Put his ideas together with those of Joschka Fischer, his foreign minister, and you have a vision of a federal Europe, with perhaps an elected president, a commission functioning as a supranational government, and a truly powerful parliament. Not so far off either: at Nice the Germans insisted on a new inter-governmental (ie, treaty-drafting) EU conference in 2004.

This is a vision shared by few French politicians. Even Jacques Delors, a former president of the commission and a leading architect of the single market and the single currency, now talks of a "confederation of nation-states" for the foreseeable future.

Reality intervenes

The two countries' alliance has often been strained, but never more so than now. And the root of the trouble is one that cannot be smoothed over: reality. Germany today is a unified giant, and most of the EU a single-currency zone. Under François Mitterrand, the French thought they could contain the new Germany by binding it into an integrated Europe. Under Mr Chirac, they fear being submerged by it, and—much like de Gaulle, resisting American hegemony—see national sovereignty as the best defence.

It is not that the Germans want to flex overgrown muscles. On coming to power in 1998, Mr Schröder said boldly, but reasonably, that it was time for Germany to be seen as a "normal" country, entitled to defend its interests. Even that he later qualified. "We cannot emerge from the self-imposed disasters of our past so easily," he admitted a year later. "Perhaps we should not even try."

Yet he was shocked at Nice by the glimpse given by Mr Chirac of France's doubts about Germany. Firmly rejecting German calls for a reform of the voting system in the EU's council of ministers that would better reflect Germany's larger population, the French president explained that, after two world wars, France wanted reconciliation, of course, but "only on the basis of absolute parity". Mr Schröder was stung. This lack of trust, obstinately entrenched despite the total change of German attitudes that had taken place in the 55 years since the war, was not what he expected from the French leader. Mr Chirac had, after all, proclaimed only a few months earlier that he, unlike some French leaders, had "always hoped for and awaited the moment when Germany would regain its unity", and welcomed the return of "a great power" to the "top table of nations".

Yet the moment Germany tried to pursue its interests, even with restraint, here were dark warnings from Paris against a new German hegemony. The Germans do not want a confrontation. But they feel it is time for France, especially its elite, to realise that the world has changed since the cold war ended. Like it or not, Germany is indeed a giant. It creates one-third of the entire euro-zone's GDP; and it will soon be the heart of an enlarged EU. Quite simply, Germany is "first among equals".

Yet Germany still needs France. It has no desire to go it alone—and knows it would run straight into an anti-German coalition if it tried. So Mr Schröder will do his best to patch up differences. As he said last week, France "remains our crucial partner" in the EU's march towards the future; a future in which, for Mr Schröder, the most important task is EU enlargement, to which he sees his federalist notions as an aid, not a contrast.

The Franco-German drive is not what it was: the two countries' last big joint initiative was on the euro, seven years ago. But the two have strong emotional ties. Michael Steiner, Mr Schröder's diplomatic adviser, talks of "an indefinable mystique", unlike that between any two other EU states.

Yet the ties may no longer be so exclusive. Increasingly, each country will probably look for other partners on some issues. The special relationship will endure, but it may become a little less special, notably until next year's French presidential election is out of the way. France is a tricky partner at present, as its neo-Gaullist president and Socialist prime minister try to cohabit, even while they prepare to fight each other in that election. The Germans will not weep if Mr Chirac loses it: Lionel Jospin, to them, seems to have a pragmatic approach to Europe and would be easier to do business with.

From the French side, the election is reason for caution. If the Germans want to propose adventurous ideas, so be it. After all, in a recent poll 55% of the French sample declared themselves in favour of Mr Fischer's ideas. But the French elections next year (let alone the municipal ones this March) will be fought on domestic issues. Why worry the voters with new ideas—and ones that divide right and left alike—on Europe?

So France will play for time. Next week's summit will be an opportunity to pretend to the world that the Franco-German alliance is again working smoothly, with far more agreement—for example, on the "European social model"—than discord. The months that follow, up to the inter-governmental conference in 2004, will provide time for the real work behind the scenes: convincing Germany that its new generation of politicians should not be too "aggressive" and that European politics, especially in a larger EU, will be the art of the possible, not the ideal.

Most of all, the French will remind the Germans of an adage from the Kohl era, repeated this month by the foreign-policy spokesman of the German opposition, Karl Lamers, in an interview with *Le Figaro*: the proper goal is not a German Europe but a European Germany.

As the Germans know, and often say—but may not relish being told.

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France

Corruption comes to court

Jan 25th 2001 | PARIS
From The Economist print edition

ELEGANT as ever, leaning nonchalantly on his walking-stick, Roland Dumas looks absolutely relaxed in the Paris courtroom—quite a feat, given that at the age of 78 he faces disgrace, a heavy fine and up to five years in prison. Only a year ago, Mr Dumas was president of France's Constitutional Council, the highest court in the land. In his time he has been variously a hero of the Resistance, a lawyer to Picasso and Chagall, and for years the foreign minister of the late President François Mitterrand. Now, in a trial that began on January 22nd, he stands accused of taking bribes and the misuse of public funds.

EPA

Defiant Deviers-Joncour

In one sense, here is an entertaining courtroom drama. One of Mr Dumas's six fellow defendants is his former mistress, Christine Deviers-Joncour, who wrote an autobiography called "The Whore of the Republic", describing her role as a lobbyist from 1989 to 1993 for the state oil company, Elf. The prosecution says her job was arranged by Mr Dumas, who had already helped install another defendant, Loik Le Floch-Prigent, as Elf's chief executive in 1989. The lucky Ms Deviers-Joncour—she admits to receiving FFr64m (over $9m) from Elf—enjoyed both a limitless expense account and a luxury apartment, and allegedly she gave the similarly lucky Mr Dumas gifts that ranged from the use of the apartment to a FFr11,000 pair of Italian shoes and a set of ancient Greek sculptures.

Yet the drama has its more troubling aspects. Was a state-owned company really urging an employee to lobby her lover, a government minister? And why? The favoured explanation, drawn not least from Ms Deviers-Joncour's writings on the subject, is that Elf was acting on behalf of another state-owned company, Thomson-CSF, which itself wanted Mr Dumas's backing for the sale of six frigates to Taiwan. Mr Dumas, who had earlier opposed the sale on the ground that it would offend China, says it was Mitterrand in person who approved it, and the ex-minister's lawyers this week sought permission to produce government documents as proof. The court, however, refused, saying the frigate affair had no direct bearing on the case. The prosecution, doubtless fearing its efforts might be blunted by security considerations, has carefully avoided any reference to the ships.

What the case amounts to is yet to be seen. Certainly, Mr Dumas's incomings far exceeded his ministerial salary. But maybe he had paintings to sell, and in any event he declared all to the taxman. He got help this week from Ms Deviers-Joncour. In March 1999, having been spurned by Mr Dumas, she grassed on him to investigators. But this week she said she had "no proof" that her lover had arranged her job at Elf, a job she described as "good for Elf and good for France", not to add for herself. Another blow for the prosecution is the absence of one of the seven accused: Alfred Sirven, alleged to have been the manager of an enormous Elf slush-fund, who has disappeared in the Philippines.

But the investigating magistrates will at least do French public morality one service, in showing up the arrogant corruption of the Mitterrand era. The late president, most notoriously, used Elf money to help finance the re-election in 1994 of Germany's chancellor, his friend Helmut Kohl. But that was just the peak of a garbage-heap of the sale of influence, kickbacks, front companies and bogus "commissions" built up under his regime (and cheerfully adapted, then and later, by its political enemies).

Mitterrand's eldest son, Jean-Christophe, is paying a bit of the price. When he was formally put under investigation last month on suspicion of profiting from arms-trafficking in Angola and money-laundering, he was summarily thrown into prison for three weeks pending payment of FFr5m in bail. The Mitterrands reckon this all smacked of vengeance: Jean-Christophe said the magistrate "sweated with hate" for him;

his mother, the late president's widow, described the huge bail as "ransom". They had a point, but not much public sympathy.

The underlying question is where it will all end. Magistrates are already investigating how political parties benefited in Paris in the 1980s and early 1990s from kickbacks from public-works contractors. This was the period when Jacques Chirac, now president, was mayor of the city. Still, he can relax, at least for the time being: the Constitutional Council, with Mr Dumas at its head, ruled in 1999 that an incumbent president has immunity not just from prosecution but from questioning.

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The Netherlands

The limits to tolerance

Jan 25th 2001 | THE HAGUE
From The Economist print edition

"I WANT to go to England, but smuggler cheated me," says Mohammad, an Afghan doctor, as he rummages through some second-hand clothes. He says that he paid a people-smuggler $20,000 to bring him, his wife and three children to Britain, only to be dumped in a "reception centre" in a grim industrial park on the outskirts of the Dutch capital, The Hague. The room they share has a sink, some battered metal lockers and a wobbly table. But at least it is safe. "Afghanistan very dangerous. I am doctor trained in Russia. Taliban [the Islamic fundamentalist government] don't like intelligentsia. I sold my house. We came through Pakistan. We stay here now."

Many asylum-seekers in the Netherlands share a similar fate. Along with 600 others who have ended up at Dutch airports or frontiers, Mohammad's family has been in this centre for months. The Dutch recognise Afghanistan as unsafe, so sanctuary is guaranteed. But those from elsewhere must prove they have fled persecution. Nearly 70,000 people, in 200 centres across the Netherlands, have applied for asylum.

The Netherlands is a popular destination. Some 38,000 foreigners, including 5,000 from Kosovo, are known to have arrived in the country in 1999. And last year, though its 15m people account for only 4% of the EU's population, it took in over 10% of the outsiders seeking asylum in the Union.

Mohammad is probably better off there than in Britain. Whereas many asylum-seekers in Britain are locked up in detention centres, the Dutch let them out as long as they register every day. Though not officially allowed to work, they get free housing, and in general a weekly allowance of 80 guilders ($30); their children are educated free. With labour in demand, some get black-market jobs as menial workers or on farms. Some are taught Dutch and are given clothes, medicine and legal advice. The government spends an average of 28,000 guilders a year on each asylum-seeker.

A sad new trend is the growing number of children who arrive on their own, knowing that under Dutch law they cannot be deported. Adults, in theory, can. But it now takes up to five years for an asylum application to be processed, so it seldom happens. Few people bring documents, which might speed up the process.

Once given permission to stay in the Netherlands, many asylum-seekers then move on, legally. For instance, the 173 Sri Lankans who arrived from Turkmenistan, without papers, at Amsterdam's Schiphol airport in 1997. Once accepted, most then pushed on to Britain or Germany.

Several European countries are becoming fed up with asylum-seekers. A law came into effect in Spain this week which could result in 30,000 illegal immigrants of one kind or another being deported. The Dutch have been among the most tolerant refugee-helpers in Europe, but in the Netherlands too the issue is becoming contentious. At the next election, due in 18 months' time, it could, for the first time, be a subject of strong debate. "People know that nobody is deported," says one politician, "but we must not be too welcoming or we create a market for human trafficking." Last November the coalition government put through a law to speed up asylum procedure by removing certain rights of appeal. Free housing will also be less easy to obtain.

Especially in the north, where there are many asylum centres, criticism from the right-wing Liberals is gaining them support. Crime is increasingly blamed on immigrants. Last month police in Amsterdam nabbed 69 Turks and people from the Balkans suspected of drug dealing. Dutch tolerance may start to wear thin.

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Charlemagne

Jose Luis Rodriguez Zapatero, Spain's new Socialist

Jan 25th 2001
From The Economist print edition

A POPULAR satirical television programme in Spain shows the new leader of the Socialist Party (PSOE), Jose Luis Rodriguez Zapatero, dressed as a Superman puppet, but with the word "Sosoman" (Dullman) emblazoned on his uniform. The jibe springs from his insistence that opposition to the centre-right government of Jose Maria Aznar should be as civilised as possible. This conciliatory approach is markedly different from that of Felipe Gonzalez, the Socialist prime minister from 1982 to 1996, and it has frustrated some of Mr Zapatero's party. Nevertheless, six months after he took over, his cool, confident style has won through.

It goes down well with voters put off by the personal antagonisms that dominated politics for most of the 1990s and seemed at times to threaten the political system itself. Just a few weeks after the PSOE elected him secretary-general last July, Spain's most trusted opinion poll gave Mr Zapatero a higher rating than Mr Aznar. He has consolidated that lead since, arguing that his task "is not to score brilliant points in opposition but to be effective as far as the voters are concerned." Well he might. In the mid-1990s, confidence in the party was dented first by a string of corruption scandals and then by Mr Gonzalez's resignation as secretary-general after he had lost the 1996 election. Two fresh leaders could not fill the void, and the Socialists suffered still worse in the election last March. Polls now say Mr Zapatero has more than halved the 15-point lead held by Mr Aznar's People's Party last June.

He has also scored on the issue that most troubles Spaniards these days, Basque terrorism. He persuaded a reluctant Mr Aznar into an agreement that the two parties would work together against the violence of the ETA separatists, and not seek political capital from it. He now proposes a similar accord on immigration, to him "a matter of state, not of party politics".

Like Mr Aznar, Mr Zapatero is a Castilian from the harshest part of the plain, north of Madrid, a breeding ground for tough, taciturn men. He was born in Valladolid, on August 4th 1960, to a professional family from nearby Leon. His father was a lawyer; his mother came from a line of doctors. The family is important to him. When his mother became ill and died last autumn, he took ten days away to nurse and then mourn her. His wife Sonsoles, a singing teacher, and their two young daughters remain firmly in the background. Mr Zapatero has resisted attempts at a makeover, although he has dropped gestures that were too obviously drawn from Mr Gonzalez's rhetorical style. He buys his dull, grey suits, uneasy on his lanky frame, in Leon.

It was the memory of his grandfather, a captain in the Republican army who was killed by Franco's troops soon after the military uprising in 1936, that led the young Zapatero into politics. He attended his first political meeting at 16, just after the dictator's death, and was impressed by Mr Gonzalez's powerful oratory. In 1978 he joined the PSOE. Of an age to remember the dictatorship but not to be obsessed by it, he has avoided the political complexes of many older Spaniards. After taking a degree in law, he taught at Leon university from 1982 to 1986, specialising in constitutional law. In 1986, he was elected to parliament and in 1988 became secretary-general of the Leon branch of the party.

Yet few had heard of Mr Zapatero before last year's leadership election. He narrowly beat much older and better known men, and is still struggling to heal divisions. But he has escaped from Mr Gonzalez's

shadow, while remaining on good terms (“Better to have Felipe inside pissing out, than outside pissing in,” a former Gonzalez minister advised him). His largely inexperienced team, however, faces resistance in many party branches.

Mr Zapatero is also difficult to pin down on policy. That may be because an election is three years away, and he sees little need to be specific. Some Socialist critics, however, say he is not a policy man but a pragmatist too ready to swing with the voters. Whatever the truth, some broad brush-strokes are in fact in place. He rules out any resurrection of the alliance with the Communist-dominated United Left that was cooked up, to little effect, for the last election. He argues that the European Union must be more closely linked to citizens’ needs, and more accountable, with a stronger parliament. “We cannot build a social Europe”, he argues, “without more politics and more democracy.” He insists, to the point of tedium, on the importance of technology, in which Spain lags behind other countries, and takes the Internet as a constant reference “to build an inter-connected European society.” But he is deliberately non-committal on the due degree of interconnection between Spain’s central government and the governments of its 17 regions, the mootest point in Spanish politics.

There is no vagueness in him, however, about market forces: the state, he insists, can create the conditions for growth, but no more. The job of government, he says, is to deregulate and ensure fair competition in every area, not just the economy. “We have to take the state out of politics and give politics back to the people.” No wonder that left-wingers in his party scathingly refer to him as a “social liberal”.

Nor that Mr Aznar should feel the new Socialist leader is encroaching on his own hard-won centre ground. The prime minister has said he will not serve a third term, but will think about the succession only a year or so before the election. That is giving Mr Zapatero space and time. He has begun by concentrating on issues that Mr Aznar tends to pooh-pooh, but which voters care about: mad-cow disease, new—publicly, at least—in Spain; the saga of a British nuclear submarine awaiting repair in Gibraltar; the depleted-uranium scare in the Balkans. Yet Mr Zapatero will not find his way left open. Mr Aznar does not plan just to grow roses at the end of his term. What he does plan he isn’t saying, but meanwhile he is determined to guard his turf. As the two men led an anti-ETA march in Barcelona last November, Mr Zapatero remarked to the prime minister that people at the sides were pushing him in towards the centre. “The centre”, growled Mr Aznar, “is mine.”

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Deep-frozen Siberia

Jan 25th 2001 | MOSCOW
From The Economist print edition

RUSSIANS take pride in a stoical attitude to the cold. But put a freak winter, rotten pipes and an incompetent government together, and even they start to get cross—notably in Siberia. Temperatures there have been particularly low in recent weeks: minus 71 degrees Celsius was recorded in the coal-mining city of Kemerovo. Heating systems, badly built in the Brezhnev era, and badly maintained since, have been giving up. Pipes have burst, power stations shut down. Some bits of the system, it turns out, were simply not designed to work in really low temperatures. And—in a country abundantly blessed with coal, oil and gas—there are growing shortages of fuel.

Each day has brought a crop of dismal news: day-long power cuts, especially in the farthest-east districts; gruesome amputations, sometimes without anaesthetic, of frostbitten victims in Irkutsk; 20 deaths from cold in neighbouring Khabarovsk. The trans-Siberian railway, Russia's main east-west link, was out of action last weekend after stretches of rail had fractured in the freeze.

Despite the cold, there have been public protests, especially in the far-eastern Maritime region, which is notoriously ill-run. But there is little real political fall-out—or even reaction from the authorities. The new regional representatives sent by the Kremlin to pep up local administrations have done next to nothing. The central government has issued ringing denunciations of everybody else's incompetence, but little more.

Russian officials like to moan about the collapse predicted for 2003, when, supposedly, the accelerating decay of heating and power systems will really start to cause pain. Many ordinary Russians, bitter and cynical about their own politicians, and about foreign banks' and goverments' inexplicable collusion with them, feel that it has begun already.

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Hungary

Scandalous confidence

Jan 25th 2001 | BUDAPEST
From The Economist print edition

SCANDAL is swirling around the populist Smallholders' Party, Viktor Orban's main coalition partner. But Hungary's right-wing prime minister looks calm. Maybe his own Fidesz party, with an economic boom to help it, will do nicely in the general election, due in spring next year.

AP

Hungary´s MPs: not all as upright as they look

The scandal first broke in October when Zoltan Szekely, then a Smallholders member of parliament, met a businessman called Daniel Balla, whose string of contracts to install municipal sewers, the MP had been suggesting, might get a parliamentary investigation. Instead, say prosecutors, Mr Szekely, sitting in Mr Balla's car, got a wad of money, some $70,000-worth. And more: it was a sting. Mr Balla had taped the conversation. As he stepped out of the car, 30-odd plain-clothes policemen swooped in. Mr Szekely is now in jail, awaiting trial on blackmail and other charges.

The affair set off a wave of allegations against the Smallholders. Where had Jozsef Torgyan, the agriculture minister and party leader, found the money to build a fancy house in a Budapest suburb? Had he obeyed the rules on the disclosure of MPs' assets? Mr Torgyan hit back, successfully insisting that parliament should investigate changes in all MPs' assets since 1990. But not all the allegations could be parried that way. The police started investigating a fund run by the environment ministry under a previous minister, also a Smallholder. Tales began to circulate that this ministry and the ministry of defence had channelled money to the Smallholders' party newspaper.

The Smallholders still hold four cabinet posts. But, with Mr Torgyan now busy ousting from the party anyone who disagrees with his own, eccentric leadership, most people reckon the party is going under. That might not worry Mr Orban much: the ideologically nearest lifeboat for ex-Smallholder floating voters would bear the name Fidesz.

Certainly, Fidesz has not helped its partner by agreeing this month to publish details of ministers' foreign travel in 1999. Cynics had long made fun of Mr Torgyan's frequent and lengthy visits to countries with few agricultural links to Hungary. It turns out that he spent nearly as many days abroad as the foreign minister. One trip was to Thailand. There too went Bela Szabadi, a junior agriculture minister, also a Smallholder, four times, on first-class tickets, in six months. Hungary's agricultural exports to Thailand totalled just $80,000 in 1999, down 29% on the year before.

Conspiracy-theorists see other grounds for Mr Orban's unconcern. He barely needs Smallholder support. Late last year parliament passed a two-year budget which should hold good until after the next general election. Apart from legislation concerned with the European Union—on which nearly all parties agree—the government has little of importance to put through.

What Mr Orban does need is support from the voters. That sounds odd. Spurred by austerity measures and privatisations introduced by the previous, Socialist-led government after a crisis in 1995, GDP grew last year by about 5.5%; industrial output may have risen more than 20%. Unemployment, less than 7%, though much higher in the country's poor east, is the lowest in Eastern Europe. Multinational companies are still coming in, albeit not as fast as a few years ago. With this to back it, the two-year budget promises bigger state pensions and better pay for public-sector workers. Spending on social services should rise. The minimum wage is already going up some 60%, if only to a sorry $140-odd a month. What more could voters want?

Meanwhile, the opposition is in chaos. The ex-communist Socialists, whom Mr Orban's party ousted from power three years ago, are at loggerheads. Their urbane leader, Laszlo Kovacs, does not strike some comrades as the man to win an election. The liberal Free Democrats have not made much impact recently, though their recent choice of a new leader, Gabor Demszky, the popular mayor of Budapest, may help.

And yet the opinion polls say that, of the voters who have made up their minds, only 33% at present intend to back Fidesz, against the Socialists' 49%. Still, Mr Orban has much to aim for: 45% of all potential voters say they have not made up their minds.

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Italy

Milan, who cares?

Jan 25th 2001 | MILAN
From The Economist print edition

AP

EVERY year the maverick mayor of Milan, Gabriele Albertini, summons the great and the good to join in a grand assembly, called the Estates General, to evaluate the city's condition. Mr Albertini, an industrialist with no previous political experience, was the right-wing Silvio Berlusconi's choice for his party's candidacy, and a good one. The Milanese like his pragmatism, his laid-back attitude and his sense of humour. Days ago, when the Northern League's uncouth leader, Umberto Bossi, hinted that the mayor was gay, Mr Albertini asked him to sign a letter of apology, which turned out to be taken straight from the film "A Fish Called Wanda".

Humour and style are not enough, though. The mayor has done a good job. But a true verdict from last weekend's Estates General could only read: doing better, but not well. Milan has recovered from the slump that followed the *Tangentopoli* ("Bribesville") scandal of the early 1990s, which propelled the Northern League, and an inadequate mayor, into the town hall. Thanks to immigrants (8% of all residents, against Italy's overall 2%), the city is no longer losing population, which is now steady at 1.3m. A good police chief has cut murder, pickpocketing and car theft by a third.

And, as most speakers reminded the audience, the city is still Italy's powerhouse. Old economy, new economy, fashion, publishing, media, advertising: no Italian city can match Milan's wealth and strength. Its exports are about 14% of Italy's total. It houses 108 banks, half of them foreign, and six universities, including Bocconi, whose MBA school is among the best in Europe. Wages are the third highest in Italy.

Yet not all is well. "The thread of the future", the title of this year's Estates General, is far from straight. Milan faces some serious difficulties.

For one, traffic, desperate in the city and often choked on the roads around it. Busy Milanese, always in a hurry, have taken to turning on their hazard lights and just leaving the car in the second lane, which often means in the middle of the road. The traffic police do not seem to care (as they have begun to in Rome, to most Milanese the epitome of traffic anarchy). The air in consequence is heavily polluted. The authorities at times ban cars on Sundays, which Milanese think is fun: Italians are masters at turning a crisis into a celebration. Fearful traffic, crazy parking—on the pavement, often—and filthy air make life hard for everyone, but especially the city's 140,000 children and 300,000 people over 65. They cannot even find refuge in parks; there aren't many.

The city has other woes. But one stretches across them all: many well-to-do Milanese have stopped worrying about such things and do not even try to change them. They feel little affection for the place.

That was not so once: Milan's grandees, incomers many of them, from all over Italy, used to be enamoured of their city. They spent money on it, chaired committees to improve it, financed the arts. Not now. Today's rich tend to live comfortably in the family house, do business all over Europe, leave on Friday for their weekends in Switzerland and come back only on Sunday night. Mayor Albertini must win them back. Milan once more needs their commitment. Their money is not enough.

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Russia

Insider inside

Jan 25th 2001 | MOSCOW
From The Economist print edition

AS HEADACHES go, this seems a pretty bad one. Russia's president, Vladimir Putin, owes a lot to Pavel Borodin, an expensively dressed man who under President Boris Yeltsin used to run the Kremlin's business empire. This week Mr Borodin was languishing in a prison cell in New York, having sent a sharp request to the Kremlin to get him home quickly.

AP

Borodin doesn´t love New York

Trying to do so publicly would be politically risky for Mr Putin. Mr Borodin was a central figure in the unpopular Yeltsin "family"—a circle of well-padded insiders who ran the country during Mr Yeltsin's frequent indispositions. Mr Borodin valued his business empire, perhaps exaggeratedly, at several hundred billion dollars, and ran it in a highly personal style that most Russians deeply resented. Rallying to his defence would suggest that Mr Putin has yet to break his ties to the people who put him in power.

Yet leaving Mr Borodin to face the Swiss request for his extradition that got him arrested is risky too. Switzerland wants him on money-laundering charges. Mr Borodin knows a great deal, probably more than anybody else, about the murky financial dealings of the Kremlin in the Yeltsin years, for most of which Mr Putin was working there as a junior, and then not-so-junior, official. If the tycoon decides to talk, his interrogators will need plenty of notebooks.

So far, Mr Putin's government has complained, but not very loudly. It has asked the Americans to let Mr Borodin out on bail, and the Swiss to drop the extradition warrant. A bail-out would merely postpone the problem. The Swiss have said no. Prosecutors there are furious with Russian footdragging in corruption cases. They failed last year to secure the conviction of a prominent and controversial Russian businessman charged with racketeering. They are unwilling to let Mr Borodin slip through their fingers now.

Swiss relations with Russia have already been strained by a row over a shipment of aid to Georgia—a load of old jeeps donated to the prison service—which the Russians confiscated, saying the jeeps might have ended up with rebels in Chechnya. Russia also suggested informally to Switzerland that handing over most of the vehicles to the Russian customs service would solve the problem. Switzerland indignantly declined, saying that the shipment was diplomatic cargo and none of Russia's business.

Until the latest row, Mr Putin had seemed to be edging away from his former backers. In recent weeks, prosecutors have questioned several Yeltsin trusties, including a former atomic-energy minister and a central-bank chairman. Although all deny wrongdoing, and no charges have been brought, such questioning would have been unthinkable a year ago. Some wonder, therefore, if the Kremlin may not have had a hand in the Borodin affair. Even if he gets home eventually, he will have had a nasty shock and looks set to be shifted from his current job (a sinecure running something called the Russian-Belarussian Union).

Others suspect a plot by the West. Certainly, the circumstances of Mr Borodin's trip, to George Bush's inauguration, are curious. He clearly assumed (wrongly) that as a senior foreign official attending a grand event, he would be as untouchable in America as in Russia. He travelled on an ordinary visa, after failing to wangle something more official. Maybe the immigration officials in New York were simply being vigilant. But maybe someone tipped them off that he was coming, or even encouraged him to go. His invitation came from an obscure Florida-based outfit called Stargate Global Strategies, which says it must have been sent by mistake. A costly one, if so, certainly for Mr Borodin and maybe for Mr Putin too.

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And all his own silly fault

Jan 25th 2001
From The Economist print edition

Peter Mandelson blamed the media for his downfall this week. He brought it upon himself, and may have driven a stake through the heart of New Labour

Get article background

Reuters

A TEMPEST in a teapot, said Downing Street at the beginning of this week. By Wednesday, the storm had not only blown Peter Mandelson out of office but also knocked Tony Blair's government sideways—and at the very moment when it had seemed to be gliding confidently to victory in the general election expected this spring.

Mr Mandelson's formal job when he resigned was as Northern Ireland secretary, a big enough responsibility in itself. Informally, he was also one of the four most powerful people in the government. As Mr Blair's courtier and *consigliere*, his influence was on a par with that of Gordon Brown, the chancellor of the exchequer, and of Alastair Campbell, the prime minister's unelected but mighty press spokesman. With Mr Brown, Mr Mandelson had been earmarked to run Labour's re-election campaign, in the hope of repeating the Labour landslide he did much to engineer in 1997. Now he has ruled himself out of that job. His going throws the party, the government and all its plans for the election into disarray.

What forced him out? The serious charge is that in 1998, as minister responsible for the Millennium Dome, he helped Srichand Hinduja, a rich Indian businessman (see article) who had promised £1m ($1.5m) for the Dome's "faith zone", to get his family the British citizenship it had previously been refused. Mr Mandelson denies this. All he did, he says, was to pass on to the relevant department, the Home Office, an inquiry from Mr Hinduja about whether a second passport application might succeed in light of new regulations that had been introduced since his first one. But Mr Mandelson does admit that he failed to make it clear, when inquiries were first made by an MP and journalists, that it was he personally, not a civil servant, who spoke by phone to a junior Home Office minister, Mike O'Brien, to relay Mr Hinduja's question.

Even by the squeaky-clean public standards New Labour claims for itself, it would be peculiar for a senior minister to resign simply for giving an unclear answer to journalists. What really seems to have done for him is that Mr Mandelson misled his closest friends in Downing Street, and that this was his second such transgression. The first—his failure to disclose a £373,000 home loan from a fellow minister—forced him to resign as secretary for trade and industry in December 1998. By bringing him back a mere ten months later as Northern Ireland secretary, Mr Blair was placing a huge bet on his old friend. It has not paid off.

Mr Blair, Mr Mandelson and Mr Campbell are the nearest thing Britain has to a ruling triumvirate (with Mr Brown running a sort of independent republic from the Treasury). This makes it all the stranger that although both Mr Blair and Mr Campbell talked to Mr Mandelson over the weekend, neither was able to wring the full story out of him. As a result, a government renowned for its mastery of spin was forced to alter its official line from one day to the next.

Over the weekend, Mr Mandelson had said that his involvement in Mr Hinduja's quest for a passport had always been "limited", not least because he was "always very sensitive to the proprieties", and had therefore ensured that the matter was handled by an official, his private secretary. On Monday January 22nd, Mr Campbell was confident enough to repeat this line at his regular press briefing. Mr Mandelson, he insisted, had refused to support the Hindujas' application, and had merely passed the matter to the Home Office. "Peter did not get involved—beyond being asked to get involved, which he did not." Journalists, Mr Campbell added, tempting fate, "could dance around the issue as much as they liked"; the facts were as he had already set out.

Except that they weren't. On Tuesday morning, Mr Campbell was having to correct himself. His new story was that a check with civil servants had jogged memories. Mr Mandelson had forgotten that it was in fact he who had spoken on Mr Hinduja's behalf to Mr O'Brien. But this detail, explained the faithful Mr Campbell, did not change the "material fact" that Mr Mandelson had done nothing improper. "All he had done was to ensure that the Home Office was aware of the inquiry which had been put to him by the Hindujas about their own status."

On Tuesday night, however, the story changed yet again. In television interviews, Mr Mandelson readily admitted that he had spoken directly to Mr O'Brien at the Home Office. But to Downing Street's consternation, he now contradicted Mr Campbell's line that he had ever forgotten about doing so. With the splash in Wednesday morning's *Sun* shouting that "Mandy told a porky", an exasperated Mr Campbell was forced to admit that "we've had problems establishing the facts". Mr Mandelson was summoned to Downing Street, spent an hour with Mr Blair, and emerged to announce for the second and almost certainly last time that he was leaving the government.

As fate would have it, Mr Mandelson resigned a few hours before both he and Mr Blair were due in Parliament to answer routine questions. William Hague, the Conservative leader, went for the jugular, mocking the prime minister for a "monumental lack of judgment" in having built up a "career-long dependency" on Mr Mandelson. These were well-aimed shafts (see Bagehot). A dejected Mr Blair could only reply that his friend had made an historic contribution in Northern Ireland and would be judged "a bigger man than many of his critics".

Maybe. But the verdict of history was not the foremost of Mr Blair's concerns this week. His immediate jobs were to limit the potential damage in Northern Ireland, restore the balance inside his cabinet, and assess the impact of Mr Mandelson's departure on his election planning.

The gap in Northern Ireland may be the easiest to fill. Mr Blair justified bringing Mr Mandelson back into the cabinet on the grounds that he alone could put the final touches to a peace that looked in danger of slipping through Mo Mowlam's fingers. But though he has done a creditable job, he too eventually made enemies in the province. John Reid, the Scottish secretary, who has taken his place, will at least bring a fresh face along with his safe pair of hands.

Mr Blair will feel the loss more keenly in domestic politics. Premierships can be wrecked by unexpected changes of cast. Sir Edward Heath never quite recovered from the sudden death of his chancellor, Ian McLeod, in 1970. In this case, Mr Blair still has a strong chancellor. But it was precisely as a counterweight to Mr Brown that Mr Mandelson was most valuable. He alone among the big beasts in government shared Mr Blair's enthusiasm for the entire New Labour project of voting reform, alliance with the Liberal Democrats and early British entry into the euro. New Labour can win the next election without him. The question is what sort of government it will be thereafter.

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The Hindujas and their passports

Jan 25th 2001
From The Economist print edition

Reuters

Gopichand, Prakash and Srichand

FROM Diwali parties to donations to the Dome, the Hinduja brothers have been assiduous in courting the establishment. Their network of acquaintances ranges far and wide. Tony and Cherie Blair were glad to attend one of their soirées. So was Lady Thatcher when she was prime minister. Other "friends" whose names the family tend to drop in casual conversation include Bill Clinton and Michael Jackson. Generous charitable giving is a hallmark of the family. Beneficiaries include the Victoria and Albert Museum, the Prince's Youth Trust and a large Hindu temple in North London.

Behind this discreet courting of politicians and other powerful people lies a £6 billion ($9 billion) international business trading empire with interests in communications and media, automobiles, financial services, oil and lubricants, and pharmaceuticals. Wealth such as this commands attention. The Hindujas' 12-storey headquarters in Haymarket, with its commanding views of Parliament and Buckingham Palace, proved a magnet for influence-peddlers.

Three of the Hinduja brothers, Srichand, Prakash and Gopichand, need as many powerful friends as they can get. They have been charged in an Indian court over allegations that they received bribes in an arms deal. The case dates back to 1986, when the Indian government signed a $1.3 billion contract with Bofors, a Swedish arms manufacturer, for the supply of 155mm howitzers to the Indian army. The brothers are alleged to have received kickbacks amounting to SKr80m ($11m) from Bofors for securing the contract. The scandal brought down Rajiv Gandhi's government. When the opposition came to power, it ordered an investigation.

The case has been looming for years. It may explain the brothers' eagerness to secure British passports. Gopichand was the first to become a British citizen. Srichand was initially turned down by John Major's government. Then he made his donation to the Dome; and, a year later, he too was granted a British passport.

Srichand insists that the two events are unrelated. "Peter Mandelson did not get me the passport or influence anyone." That was certainly true in Prakash's case: despite Mr Mandelson's intervention on his behalf, he is still an Indian citizen.

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Vaccines

Shots fired

Jan 25th 2001
From The Economist print edition

Reports that the measles, mumps and rubella vaccination is dangerous are reducing take-up and threatening a resurgence of diseases

SINCE their introduction more than two centuries ago, vaccines have worked wonders in controlling disease, but they have proved rather less successful at quelling controversy about their safety. The latest outbreak of public panic centres on fears that the shots given to toddlers to prevent three nasty childhood diseases—measles, mumps and rubella (MMR)—might cause bowel disease and autism.

Three years ago, Andrew Wakefield and his colleagues at the Royal Free Hospital in London reported a dozen curious cases of normal children who suddenly developed behavioural problems and intestinal complaints. Dr Wakefield suggested that their symptoms might be linked to a vaccine, introduced in 1988, to protect children against MMR in a single shot, replacing the earlier practice of immunising just against measles. Dr Wakefield speculated that the combined vaccine might somehow disrupt the gut, allowing molecules which normally stay safely in the intestine to leak into the bloodstream and cause problems in the brain just days after immunisation.

Dr Wakefield's findings, and his hypothesis, have been hotly disputed ever since. Critics argue that his study was too small and too biased to make such a connection, and that the experience of millions of children immunised throughout the world without serious complications support the vaccine's safety. Undaunted, this week Dr Wakefield has fired another salvo against the vaccine, charging that the original safety trials leading to its adoption in Britain were too brief to detect these complications and that he now has almost 170 cases on his books to support their association with the MMR jabs.

Dr Wakefield's latest work has been as heavily criticised as his previous paper. Helen Bedford, a researcher at the Institute for Child Health in London, says that his review of earlier safety studies, just published in the journal *Adverse Drug Reactions*, is not only mistaken in some of its facts, but also highly selective, ignoring important recent findings. Much of this work has been done by a group at the University of Helsinki; their most recent study, published last month, looking at 1.8m children who received the MMR vaccine between 1982 and 1996, detected only 95 serious reactions linked to the vaccine, with no cases of inflammatory bowel disease or autism reported.

Compared with this and other large, long-term studies, Dr Wakefield's evidence seems anecdotal and unconvincing to most public-health specialists. But his colleague, Scott Montgomery at the Karolinska Institute in Sweden, notes that the way the Finnish study was designed would not allow researchers to pick up autism which, unlike an acute attack of fever, might appear in such a subtle and gradual way that parents would not think to report it as a vaccine side-effect. Whether Dr Wakefield's claim in the popular press of more than 150 new cases will persuade sceptics remains to be seen, since only one part of his findings has been published in a serious, peer-reviewed scientific journal.

In the meantime, Dr Wakefield has suggested that parents opt to have their children immunised against these diseases one at a time, rather than expose them to the combined vaccine. But as Dr Bedford points out, the more shots people must take, the less likely they are to take them, leaving them open to infection. Since 1998, British MMR vaccination rates have fallen from 92% to 88%. This is below the level of coverage needed to keep the diseases at bay. Thirty years ago, there were anecdotal reports of a link between whooping-cough vaccination and infant brain damage. Although further investigation proved this to be an exceptionally rare complication, immunisation rates plunged in Britain and the disease exploded, killing 70, three-quarters the number who died in the last year before the vaccine was introduced. This time round, the government proposes to launch a £3m ($4.5m) advertising campaign to help jog the national memory about the misery of measles, mumps and rubella.

But since the problems over BSE, people are less inclined to listen to reassuring noises from government on scientific matters and more inclined to hear the voices of doom. Two years ago, newspaper reports about the bad things that genetically modified foods did to rats sparked a public revolt against the technology which officials failed to put down. The science did not stand up to scrutiny, but the damage was already done. The dangers of a growing revolt against vaccines are much greater.

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Battle of Trafalgar Square

Jan 25th 2001
From The Economist print edition

ONE man's essential scientific experiment is another man's violation of animal rights. One man's ancient rural sport is another man's bloody outrage. And one man's lovable symbol of London is another man's "rat with wings".

EPA

Banks confers with supporters

The last man in question is Ken Livingstone, the mayor of London. After a week in which the rights of foxes not to be hunted, and the rights of animals not to be experimented on, were vigorously advanced in Parliament and outside pharmaceutical firms, Mr Livingstone has provoked yet another animal-rights battle. Although he firmly opposes foxhunting and lovingly tends a famous collection of newts, Mr Livingstone's feeling for less privileged species than his own does not extend to the pigeons in Trafalgar Square.

The mayor argues that the pigeons constitute a health risk, and that the square would be more fun without them. The statues would certainly be cleaner—though Mr Livingstone has provoked another row by arguing that some of those fusty old military figures (the statues, you understand) ought to be culled as well. Now he wants to cut off the pigeons' food supply. To that end, he has imposed a ban on the square's only seller of pigeon food.

No doubt the mayor has a point. But to some, pigeons are as much a part of Trafalgar Square as Nelson's Column; and the birds have a surprisingly wide network of allies. Tony Banks, MP, a veteran animal-rights campaigner, worries that the mayor will drive the pigeons to starvation. He argues that since people also make a mess, according to the mayor's reasoning they should also be removed. (Londoners must hope that the mayor is not persuaded by this reckless line of argument.) There is a personal dimension to the battle: Mr Livingstone and Mr Banks have been rivals in London's Labour Party for decades.

Mr Banks, however, is not alone in his opposition to the mayor's square-cleansing. Pigeon-lovers flocked to a defiant "feed-in" in the square this week to show their support. And the pigeon alliance spans the Atlantic. On a visit to Washington, DC, last week Mr Livingstone was pelted with water by an animal-rights activist, who called him a pigeon-murderer. "At least it wasn't pigeon poo," said the mayor, dampened but unbowed.

Balancing the rights of pigeons, humans and statues could prove tricky. Lengthy reports and consultations may be needed. At the moment, Mr Livingstone appears to be losing the battle. The courts have temporarily revoked the pigeon-food ban. But a solution could yet be found, combining the mayor's hostility to pigeons with his kindlier feelings towards foxes. Let the foxes exercise their right to take refuge in Trafalgar Square.

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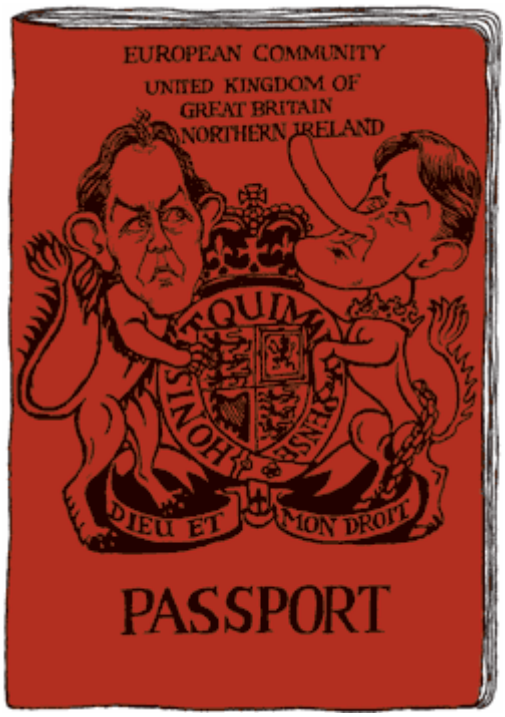
Bagehot

The meaning of Mandelson (continued)

Jan 25th 2001
From The Economist print edition

Get article background

IT IS not surprising that Downing Street broke with tradition this week and chose not to publish the usual pompous letters that pass between prime ministers and disgraced cabinet members when the latter resign. As is well known, history repeats itself first as farce and next as tragedy. Or is it the other way round? Either way, it would have been farcical for Peter Mandelson to have written for a second time to his boss saying how privileged he was to have served New Labour, etc, etc; and for Tony Blair to have written back through crocodile tears repeating all the glutinous sentiments about his own great sorrow, and holding out yet again the prospect of some future return to the New Labour fold.



If nothing else, the journalists whom Mr Mandelson courted, spun, lorded it over and ultimately blamed for his downfall, would have had vicious fun making a story out of the second exchange of letters. They would have compared them, line by line, with the letters that were exchanged the first time Mr Mandelson resigned, in December 1998, when it was revealed that he owed £373,000 ($618,000) to Geoffrey Robinson, a Treasury minister, but had failed to say so even when Mr Robinson's businesses were being investigated by Mr Mandelson's Department of Trade and Industry. This time round, Mr Blair could have held out no prospect of future redemption to his twice-disgraced friend. The prime minister showed his fondness for Mr Mandelson once, by bringing him back as Northern Ireland secretary indecently soon after the first delinquency. This second strike puts him out for good.

Another pompous convention when cabinet ministers resign is for commentators and inwardly exulting rivals to declaim soberly, as in "Macbeth", that nothing so became the fallen man in his political life as the leaving of it. But although Mr Mandelson was dignified enough on the day he resigned, he resigned without apology, hinting that the true blame lay with officials, or the media, and that he had done nothing improper. This may be true in the narrow sense that, when Srichand Hinduja inquired politely in 1998 about his chances, at the second time of asking, of getting a British passport, Mr Mandelson did not get on the blower to a junior minister in the Home Office and order him to grant Mr Hinduja's wish simply because this fine man had promised to donate piles of lolly for the Millennium Dome. On the other hand, Mr Mandelson did get on the blower to a junior minister at the Home Office to "pass on" Mr Hinduja's inquiry—which you may think, since junior ministers are not complete idiots, amounts to the same thing.

Mr Mandelson's complaint as he resigned about the media's "dogging" him over the past five years, and his plea to be allowed a "more normal life", are no less preposterous. Enoch Powell once said that any politician who complained about the press was like a ship's captain who complained about the sea. But in this respect Mr Mandelson has never been "any politician". He built his whole career in the Labour Party upon the media-savvy reputation he acquired as its director of communications in the 1980s. He has revelled in his mastery of spin, the power he acquired by leaking or withholding information to or from individual journalists, and his awe-inspiring sobriquet as the "prince of darkness". Although government ministers grumbled this week that Mr Mandelson had fallen because the media had called for his head, this is untrue. Most newspapermen expected him to survive and were stunned when he went. It was in fact Mr Blair, and the prime minister's strangely powerful press spokesman, Alastair Campbell, who lopped off his head when they tired of trying to get a straight story out of him about Mr Hinduja. As for

craving a “normal life”, pull the other one. Mr Mandelson had serious enough aims in politics, principally those of making Labour electable again after its suicidal tilt to the left after 1979, and moving Britain closer to the European Union. Much of his work as a minister in the Cabinet Office and then in Northern Ireland was done well. But he also saw politics as an arena in which to make himself highly abnormal. That is why he needed the flashy home he bought with Mr Robinson’s loan, why he cultivated celebrities, why he showed off and hogged the limelight—and why he alienated so many of the “more normal” MPs in his own party.

Many of those are delighted by his fall from grace, not only because they disliked him (though they did), but also because they quietly agreed with William Hague, the Conservative leader, who said this week that the prime minister had become over-dependent on his prince of darkness. Mr Blair’s confidence in Mr Mandelson especially infuriated Gordon Brown, the chancellor of the exchequer, who believes he might today have been prime minister if Mr Mandelson had not betrayed him by throwing his support behind Mr Blair in the succession battle that followed the death of the party’s former leader, John Smith, in 1994. The tension between these three men created a vicious triangle at the centre of the party when it was in opposition, and the same geometry has persisted in government. In 1996 Mr Blair wrote to Mr Mandelson pleading for an end to the “Titanic but ultimately irrelevant personality feud” between him and Mr Brown, whom he considered in their different ways “the most brilliant minds of their generation”. The flattery solved nothing. Until this week, Mr Mandelson had been expected to mastermind Labour’s re-election campaign in partnership with Mr Brown. Minions in the war-room at the party’s London headquarters had been wondering aloud whether the two masterminds would talk civilly to each other.

If Mr Mandelson really does possess one of the greatest minds of his generation, he will have now to prove it outside government. He was not inside for long enough to prove anything much—except perhaps the dangers that befall a prime minister who chooses to rule through a coterie instead of a cabinet.

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Immigration

Go away, we need you

Jan 25th 2001
From The Economist print edition

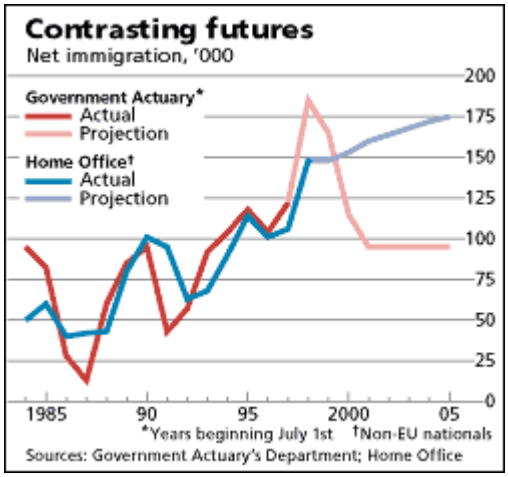
MIGRANTS, according to research published by the Home Office this week, can help boost growth, reduce inflationary pressure and fill labour-market shortages. Self-selection by migrants means that they are likely to be especially resourceful, entrepreneurial and ambitious. Can these paragons of economic virtue be in any way related to the hordes of asylum-seekers, many of them "bogus", that the government is seeking to deter by one method after another, including the building of new detention centres?

Politics and economics are pulling the government in different directions on immigration. A record number of people applied for asylum last year—more than 75,000, or around 100,000 including dependants. Labour knows that many British voters want less immigration. On the other hand, skills shortages are increasingly apparent, especially in the public sector. The speed with which the government has executed a U-turn in its approach to immigration owes much to its need to bring in foreign workers to meet its recruitment targets for the NHS and education.

The government now wants to encourage "managed migration". The Home Office research, putting a positive spin on migration, is part of this strategy. Barbara Roche, the immigration minister, says "the contribution migrants have made to this country is clear, and I believe the potential to enhance that is becoming clearer."

The contradiction in the government's stance towards immigration will become more acute if the Home Office research is correct. It argues that migration pressures are mounting inexorably. On the basis of recent inflows, it predicts that net migration into the United Kingdom—the balance between inflows of immigrants and outflows of emigrants, excluding EU nationals—will rise in the next five years (see chart).

This prediction flies in the face of the government's official projections, made by the Government Actuary's Department (GAD). These show the overall balance of net migration (including EU nationals) swiftly halving from a net inward flow in 1999 of 182,000. From 2002, GAD projects a continuing net inflow of 95,000 a year. These GAD projections are vital building-blocks for government programmes and policies. For example, they generate forecasts for the growth in households that are central to planning decisions about the number of new homes that might be required.



The GAD projection already shows that migration will account for just over half the increase in Britain's population of 4.4m between 1998 and 2021. The remainder is accounted for by natural increase (more births than deaths). So if migration remains at its current high levels—or even rises still further—this will lead to more rapid population growth than is currently expected. The increase in numbers will be biggest in London and the south-east, where more than two-thirds of new migrants are settling. The effect, says David Coleman, a demographer at Oxford University, will be to "wreck Mr Prescott's attempts to stop concreting over the south-east of England."

The economic, social and cultural implications of higher net migration will be far-reaching. So which of the contrasting futures set out by GAD and the Home Office is the more plausible? The GAD projection assumes, in effect, that recent inflows are exceptional, generated in particular by high inflows of asylum-seekers.

The Home Office research, by contrast, argues that high immigration is here to stay. It challenges the view that policy alone can determine the level of migration. Rather, the recent rise in immigration reflects

four forces: the strength of the British labour market, globalisation, increasing economic integration and labour mobility within the EU, and rising political instability around the world. Since these forces are likely to persist, we can expect higher immigration. In particular, demographic pressures—the prospective fall in the working-age population in the absence of net migration—will tend to keep the labour market tight, so attracting more immigrants.

So which one of these calculations will turn out to be right? The eventual outcome will probably lie somewhere between the GAD projection and the Home Office prediction. John Salt, director of the migration research unit at University College London, part of London University, thinks that net inward migration will fall if the number of asylum-seekers can be reduced. However, Mr Salt still expects that migration will remain relatively high.

Mr Salt attributes the change in government thinking on immigration to a recognition that “there is a global skills market and that those that compete best in it will succeed.” But voters may not appreciate the economic imperative. Last year’s *British Social Attitudes* survey showed that a majority of working-class people, including those who support Labour, think that immigrants take jobs away from people born in Britain. Too positive an espousal of immigration and Labour risks alienating its core voters, who may then retaliate by not turning out. Expect ministers to carry on blowing hot and cold about immigration.

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Breach birth

Jan 25th 2001 | MOSCOW
From The Economist print edition

DUPLICITY and chicanery are their stock-in-trade, so is it any surprise that spies sometimes break their own rules? More surprising is the mess that the Secret Intelligence Service (SIS) has made of dealing with Richard Tomlinson, a renegade spook whom it fired in 1995.

Instead of leaving quietly for a nice job in investment banking or public relations, Mr Tomlinson tried to take the SIS (usually known by its informal name, MI6) to court, claiming unfair dismissal. When MI6 blocked this, citing national security, Mr Tomlinson tried to strengthen his hand by leaking titbits to newspapers and threatening to publish a book. He was prosecuted, jailed, released, and then went abroad and continued leaking, with intermittent arrests and harassment by foreign intelligence services acting on MI6's behalf.

MI6 got an injunction to prevent Mr Tomlinson publishing anything he learned during his time as a spy, but Mr Tomlinson went on with his book, planning to publish it in Moscow and selling the serialisation rights to the *Sunday Times*. The High Court ruled that the *Sunday Times* could serialise the book once it became widely available, and the Court of Appeal upheld this judgment on January 25th. The book was due to be published on January 22nd; but Mr Tomlinson's mysterious publishers mysteriously postponed publication. The *Daily Telegraph* (comprehensively briefed by British intelligence) has implied that Mr Tomlinson is being exploited by Russian intelligence.

In previous leaks, Mr Tomlinson has claimed that MI6 tried to assassinate Slobodan Milosevic of Yugoslavia (fair enough, many British taxpayers might think) and Princess Diana (that's different). He also says it recruited a top official of Germany's Bundesbank.

Excerpts of the book, "The Big Breach", are already available on the publisher's website (www.thebigbreach.com), and copies are circulating in Moscow. There are some enjoyable anecdotes—that as part of their training, for instance, MI6 recruits are given an hour to get the name, phone number and passport number of a randomly selected member of the public.

But there is little useful information in this breathless, whingeing and ill-written volume that a diligent reader of books about spying would not know already. That MI6 agents are trained at Fort Monckton, near Portsmouth, for example, appeared in 1997 in an (officially blessed) book about the Falklands war. It should surprise nobody that spies often pretend to be businessmen or journalists (as Mr Tomlinson did himself, he says).

The most interesting issue is why MI6 has got itself in this mess. Geopolitics is part of the problem. Running a secret intelligence organisation is a difficult business, now that the moral discipline of the cold war has crumbled: when spying for your country is about making its big businesses richer, rather than subverting totalitarianism, patriotism may not be enough to keep a disgruntled ex-employee quiet.

But the *Zeitgeist* is not wholly to blame. Part of the fault also lies with MI6, which evidently has a problem in its human-resources department. Recruiting Mr Tomlinson looks like a bad mistake, and his sacking seems to have been clumsily handled. And the principle that spies should be bound by lifelong secrecy might be easier to uphold if Stella Rimington, the former head of Britain's internal security service (known as MI5), were not about to publish her own memoirs.

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Remember, remember

Jan 25th 2001
From The Economist print edition

“WHO now talks about the massacre of the Armenians?”, Hitler once asked his henchmen. Not those presiding at Britain’s first official Holocaust Memorial day, on January 27th, the date Auschwitz-Birkenau was liberated by the Red Army. The main ceremony will not dwell on the widespread killing of Armenians by Turks in 1915-17. The Home Office, which is organising the event, says that the focus will be on atrocities committed during and after the second world war. It will thus avoid upsetting the Turkish government, which is very sensitive about the Armenian question. When the French parliament last week acknowledged that the Armenians had faced genocide, Turkey recalled its ambassador.

The memorial day is supposed to embrace individuals of all faiths and political parties in a collective act of commemoration. So it would be nice to think that squabbling over who should be included and who suffered most could, in the circumstances, be avoided. Because of its scale and the Nazis’ meticulous record-keeping, the Holocaust can reasonably serve as an exemplar of atrocity. But unfortunately, as the Armenian issue testifies, commemoration, especially the state-sponsored kind, is deeply political. This applies not only to who is being remembered, but also to who is doing the remembering and why.

The Holocaust is definitely in vogue. It has recently inspired a series of successful films, as well as official memorial days in several European countries. In Britain, the Holocaust is the subject of an exhibition which opened last year at the Imperial War Museum. This recent prominence has perhaps been caused partly by the sort of retrospection that the ends of centuries arouse. As Tony Blair says, most of the eyewitnesses to the events of the second world war have now died, so arguably the need for some sort of official memorial has increased.

But the immediate reason why Britain has its own memorial day is that Mr Blair and Jack Straw wanted one. They have explicitly related the event to New Labour’s wish to forge a tolerant, multicultural society. Of course, that sentiment is in itself unobjectionable. But cynics will conclude that the politicians are using the Holocaust to bolster their own moral credentials. Stephen Smith, director of the Beth Shalom Holocaust centre in Nottingham, who has been involved with planning the day, says he is disappointed that the service will not mention the failure of the British governments of the 1930s and 1940s to respond adequately to Nazi anti-Semitism. So the credentials of past British governments will also emerge, if not bolstered, at least unscathed.

As well as the main national ceremony, the memorial day will involve activity in schools and special programmes on television. The idea is to prevent genocide from occurring in the future. But there is a savage irony in commemorating the post-war atrocities in Bosnia, Rwanda and Cambodia, alongside the Holocaust. Commemoration is more than mere hand-wringing only when it leads to resolve. Often, it does not.

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The rich

The American way of giving

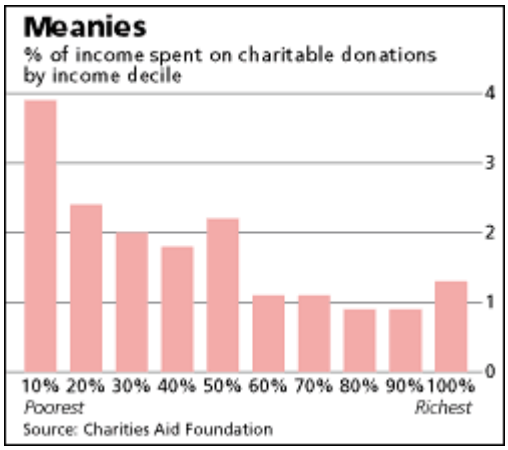
Jan 25th 2001
From The Economist print edition

Compared with Americans, Britain's rich are rather tight, and very discreet. They are changing, in both ways

IN AT least one way, the forthcoming general election will be different from its predecessors: the two main parties will, for the first time, be relying on the financial backing of a few rich people. Stuart Wheeler's gift of £5m to the Conservative Party, with the promise of more to come, is by some way the largest donation ever made to the party. And it more than matches the gifts of £2m each pledged by three donors to the Labour Party in recent weeks. Wealthy Brits seem to be giving their money away in larger lumps than before—and not just to political parties.

The British rich are not known for their generosity. They give much less as a proportion of their income than the poor (see chart). And the super-rich give less than in America, though that is partly to do with the way the American tax system encourages giving.

This week in America the *Chronicle of Philanthropy* published its annual "60 Largest American Charitable Contributions 2000", complete with snaps of the smiling donors. Heading the list are Bill and Melinda Gates, who topped up their foundation with another odd $5 billion (£3.3 billion), taking its total assets to $21 billion. Of the 60 donors, 40 gave their money directly to their old universities or colleges, or to projects helping inner-city schools. Grants of this kind totalled about $1.8 billion.



The most recent tally of British giving was published in 1994 by the Directory of Social Change, which put together a list of the country's top "Millionaire Givers". It ranked them by how much they gave as a proportion of their income. The financier George Soros, who gave £100m, came top; the rest gave a total of £75m.

That miserly figure may be the result of modesty as well as meanness. Just as making a lot of money is still regarded as being slightly vulgar in polite society, nor will it do to be too open about how much you give away. The names of Labour's three big recent donors were released after claims in the press that the party was trying to slip them through before a change in the law, which would require their publication, came into force. The list in "Millionaire Givers" caused such a storm that it was never updated. The wealthy (through their solicitors) claimed that their privacy had been invaded, and charities said this would discourage more giving. Britain has plenty of "rich lists", but no "giving lists".

But now there are signs that Britain's rich are following their American cousins' way of giving more, more openly and more directly. A new bunch of rich people has sprung up to compete with the old philanthropic families such as the Westons, the Sainsburys and the Clores. A magazine called *WealthWatch* estimates that the number of millionaires in Britain has doubled in the past five years, up from 100,000 in 1996 to 200,000. This new wealth mainly reflects the impressive performance of the stockmarket over the period.

Christopher Ondaatje, who gave £2m to the Labour Party, also donated £2.5m towards the building of the new wing of the National Portrait Gallery. Joanne Rowling, the author of the Harry Potter books, has given £500,000 to the National Council for One Parent Families and promised the proceeds from two new books, worth about £22m, to Comic Relief. Eric Clapton, a musician, sold his guitar collection in 1999 to raise money for his drug-rehabilitation project in Antigua, to which he is reported to have given £7m. Anita Roddick has given millions to the Body Shop Foundation, and has pledged to leave most of her

considerable fortune to it.

Some of the new British rich are following the example of American-style “social entrepreneurs”. Instead of just putting aside money for some vaguely benevolent purpose, they bring their business skill and drive to solve social problems with their own money. Peter Lampl, who made his fortune in America, set up the Sutton Trust to provide better access to higher education for children from poorer families. Peter Ogden, who made his money in computers, set up the £23m Ogden Trust to fund places for bright working-class children at the top public schools. This directly replaces the assisted-places scheme abolished by the Labour government. These men rely on publicity to make their projects work.

Fund-raising itself is becoming more professional. It has to be: galleries and museums now rely heavily on fund-raising since the proportion of their income from government has gone down, and the best fund-raisers know how to go after the rich. London now has its own circuit of American-style charity balls and galas, replete with celebrities and promotional gimmicks, all lovingly chronicled in the pages of *Hello*.

But the British rich have a problem, according to a banker who looks after “high net worth individuals”. They don’t know how to dispense with their extra cash—who to give to, how to extract the best deal from the taxman and how to make sure their money is well used. Help, fortunately, is at hand: a firm of London solicitors and University College, part of London University, have just founded the country’s first Institute for Philanthropy. It will dispense advice to those overburdened with money, and help them give more of it away.

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Kabila is dead, long live Kabila

Jan 25th 2001 | KINSHASA
From The Economist print edition

Joseph Kabila has inherited Congo's presidency from his father Laurent, but not much power to go with it

Get article background

EPA

CONGO buried its assassinated president, Laurent Kabila, this week with full military pomp at a marble mausoleum in the capital, Kinshasa. The following day his son, Joseph, was to be inaugurated as president but the ceremony was at first delayed, apparently to allow parliament, handpicked by his father, to ratify the succession.

In death, Mr Kabila inspired an upsurge of nationalism, something he had never managed to achieve in life. His funeral ceremony, held in the vast Chinese-built People's Palace, was marked by outbursts of anger against Rwanda and Uganda. Those two countries invaded Congo in 1998 in support of rebel movements, and still control much of its territory. Gaetan Kakudji, Mr Kabila's cousin and Congo's interior minister, reminded the crowd of that, bringing the ceremony to a close with a blast of nationalist fury. The crowds pressing around the palace compound bayed their approval, vowing to avenge the president's murder and punish the colonialists who plotted it.

If that mood continues, so will the war. The new President Kabila may just be a stop-gap, quickly appointed to ensure continuity and avoid a power struggle that might benefit the rebels. None of the regime's faces have changed save the president's and the old guard insists there will be no policy changes either. But in private some of the inner circle admit that their new leader is willing to open talks with the rebels and the countries that support them. That would be a huge departure from his father's stubborn attitude, which even his allies had seen as the main obstacle to peace.

Louis Michel, the foreign minister of Belgium, Congo's former colonial power, has embarked on a mission to harness these hopes. After attending the funeral, he set out for exploratory talks with every neighbouring power involved in the war. "What we have heard from the Rwandans, the rebels and the administration here suggests some faint signs for optimism," his spokesman said. Businessmen in Kinshasa also showed signs of optimism: the Congolese franc regained a third of its value against the dollar the day after Mr Kabila's death. The two Ugandan-backed rebel groups, the Movement for the Liberation of Congo and the Rally for Congolese Democracy, have just agreed to merge, slightly simplifying the process of negotiation.

But the young Mr Kabila makes an improbable peace-broker for such an intractable conflict. He is an unknown, callow youth between 28 and 31 years old, promoted to the rank of major-general by his father after some military training in China. He speaks the official national language, French, poorly and the unofficial one, Lingala, not at all. He said nothing at his father's funeral and has yet to address the nation. He has given only one recent interview, in English, to Zimbabwean television.

Mr Kabila may not even have the power to make peace. His father's funeral clearly showed who is now calling the shots in Congo. The soldiers closely guarding the president were not Congolese but Zimbabweans and Angolans. The Congolese troops remained outside the building, without bullets in their guns, according to some reports. On the dais, Mr Kabila received the presidents who will, at least in the short term, be his masters: Sam Nujoma of Namibia, Robert Mugabe of Zimbabwe and, especially, Eduardo dos Santos of Angola.

In the past, the Angolan president had expressed exasperation at the late Mr Kabila's failure to implement the 1999 Lusaka peace accord that would have ended the civil war. Since the assassination, Angola has hugely increased the number of its troops in Congo to more than 4,000. Some of them now control critical places such as the airport, while Congolese soldiers sit idle in their barracks. Angola's influence is rivalled only by that of Zimbabwe, which has more troops in the country, including the bodyguard that surrounds the new president at his home, the Marble Palace.

So did the Angolans or Zimbabweans instigate their ally's murder? There are some signs that the killing was planned, not simply the act of a single crazed gunman as the official version has it. There was no panic in the government after the assassination, diplomatic sources say. Although Mr Kabila almost certainly died within minutes or hours of his shooting, his body was flown to Harare, ostensibly for treatment but probably merely to give the government time to reorganise and agree on a successor. Orders were issued in his name and the death was kept secret for 50 hours. As a result, Kinshasa remained calm and factions in the army that might have risen up were disarmed. But if Mr Kabila's killing was planned—and it may well have arisen just from discontent among the palace guard—it is still not clear what it was meant to achieve.

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Morocco

Royal gulag

Jan 25th 2001 | RABAT
From The Economist print edition

FOR years, Tazmamart death camp has haunted Ahmed Marzouki. Now—thanks to the publication of his memoirs and the press coverage they are generating—it is haunting Morocco's rulers.

Reuters

They want to know more

Mr Marzouki was 23 when he and 57 other rebellious army officers were interned at Tazmamart, a former barracks on the fringes of the Sahara. He was 41 when he was released. He spent the intervening 18 years locked in a tiny windowless cage: Cell 10, Block 1. The only light came from 15 pinpricks in the corrugated-iron roof. The same cracks supplied the only hint of fresh air, and, via a hanging thread, dewdrops to quench his thirst. Less than half the imprisoned officers came out alive. In the darkness, Mr Marzouki tallied the deaths of his comrades by the squeaking of the wheelbarrows brought in to cart off their bodies. Tazmamart was just one of a dozen secret detention centres where King Hassan II, who died in 1999, left hundreds of victims to rot.

Mr Marzouki says he has written the book, "Cell 10", to ensure that such horrors never recur in Morocco. But could they? King Mohammed VI, Hassan's son and successor, has struggled to distance himself from the horrors of his father's regime. Whereas Hassan at first denied the existence of Tazmamart, and later claimed falsely that the camp had been destroyed, Mohammed has allowed a visit to the site, and awarded the victims millions of dollars.

Mohammed is challenging his father's legacy in other areas too. In the past, questioning the financial practices of the palace was a criminal offence. Now, for the first time, Morocco's parliament is holding an unrestricted inquiry into a state bank, Crédit Immobilier et Hotelier (CIH), which mislaid hundreds of millions of dollars under the management of Hassan's cronies. The commission has summoned prominent members of the dead king's entourage to explain why loans were made to build shipyards in Marrakesh, 160km (100 miles) from the sea, and why public money was used to offset them. Parliament voted last week to make the report public. Day by day, it grows clearer that scandals such as Tazmamart and the CIH were not aberrations, but part of the pattern of Hassan's rule.

The more Moroccans learn, the more they demand to know. Editorialists have called on the king to initiate trials of Tazmamart's warders and the CIH's managers. But by washing too much dirty linen in public, Mohammed risks a backlash from the old guard of his father's court. Already there are signs of dissent: on the United Nations' human-rights day, four hours after Mohammed gave a televised address promising to improve Morocco's record, his security forces banned all rallies to mark the occasion, and beat those who defied them. Activists who revealed the names of generals with Moroccan blood on their hands met the same fate. "Just because a woman removes her veil, it doesn't mean she has to perform a striptease," a senior official gripes.

In an attempt to rise above the fray, the king has devolved day-to-day decision-making to his government. Ministers from the elected parliament now wield real power, under a prime minister who, although appointed by the king, is a former leftist revolutionary and inmate of Hassan's jails. The king, meanwhile, spends much of his time touring impoverished rural communities, ladling out soup and sympathy to peasants before a troupe of photographers. In other words, he is behaving as a real constitutional monarch should do.

But the government appears unprepared for its growing autonomy. On delicate subjects ranging from privatisation to women's right to divorce, the buck passes back and forth between the palace and the

cabinet. “The only person who can impose change is the king,” says a former palace adviser. “The country is simply not ready for a constitutional monarch.”

Into the vacuum advances the army. Under Mohammed, the generals have won control of both foreign and internal intelligence, blurring a separation that Hassan judged vital to stave off military coups. The generals sense republicans everywhere, and view Morocco’s democracy movement as the king’s natural enemy. Military police and even tanks have been sent to crush Islamist protests, round up demonstrators and haul them into court. Despite the king’s popular push for reform, the spectre of Tazmamart is not yet distant enough to be forgotten.

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Marriage and divorce, Emirates-style

Jan 25th 2001 | DUBAI
From The Economist print edition

THE United Arab Emirates does not want its citizens to marry foreigners. A government-financed group, the UAE Marriage Fund, says that mixed marriages, especially if they involve a non-Muslim, threaten social stability. It says 28% of the country's 1m people are married to a foreigner—and that 79% of UAE men who divorce local wives go on to marry a foreign one. In future, foreign women aged under 40 will not receive a visa unless they travel with a male relation, in accordance with Muslim tradition.

Jamal Al Bah, who directs the Marriage Fund, argues that the government should enforce a rule to reduce or even forbid mixed marriages, as in neighbouring Oman. Such marriages, he claims, lead to drug abuse, high divorce rates and the loss of the country's Arab and Muslim heritage. They have also caused an excess of local spinsters. Since spinsterhood starts at 30 in the Gulf, the fund recently introduced a 20,000 dirhams ($5,000) premium for citizens who marry "older" UAE women—anyone over 30—in addition to the 70,000 dirhams the fund generally dishes out for wedding costs and dowry when citizens marry each other.

About ten years ago, a survey showed that many men in the Emirates could not afford to get married. So the Marriage Fund was started in 1992 with a hefty $440m donation from President Zayed bin Sultan al-Nahayan. To save money, the fund organises mass weddings for dozens of couples throughout the country. It is also considering cash bonuses for men who marry widows and divorcees.

The pattern of divorce reveals a contradiction at the heart of UAE society. Statistics show that only 4% of divorced UAE women have a secondary-school certificate, and only 1% are university graduates. The UAE encourages education, and more and more women are enrolling for college and university. Yet custom encourages women to marry young, often to a cousin. At one and the same time, the Emirates wants girls to follow the traditions of their parents and the country to have the benefit of educated women. The prospect of spinsterhood is not appealing—but nor are the divorce courts.

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Refugees

Changed course

Jan 25th 2001
From The Economist print edition

IT WAS an inauspicious beginning for Ruud Lubbers, the new United Nations high commissioner for refugees. No sooner had Kofi Annan, the UN's secretary-general, settled on him than the chorus began: what did this career politician (and Dutch prime minister of 12 years) know about refugees? Various UN countries, UNHCR staff and many of the 500 non-governmental organisations (NGOs) that do business with the agency complained that the selection procedure was murky and undemocratic. Even the Dutch government took to grumbling—it had wanted Jan Pronk, a feisty, leftish minister, to get the job instead.

Her budget is falling

Many suspect Mr Lubbers got the nod along with orders from donor countries to cut the UNHCR down to size. It has become the UN's most prominent agency, with a conspicuous role amid the Balkans' various conflicts and broad responsibility for the 14m or so refugees around the world. Until now, it has also had a plump budget of $1 billion a year. Sure enough, amid celebrations of its 50th anniversary in December, the UNHCR's main donors threatened to slash its budget. On January 24th, Mr Lubbers conceded that his budget would indeed drop well below $1 billion. In return for accepting lower contributions, he hopes to fix them at a regular level, ending the agency's dependence on the fluctuating whims of donors.

He also wants to strip away some of the UNHCR's duties and turn it into more of a co-ordinating agency. Much of the actual relief work—giving refugees food, shelter and other services—could be farmed out to NGOs instead. But even if more money flows directly to NGOs, Mr Lubbers wants donors to make UNHCR oversight a condition of their grants. Other agencies, such as the World Food Programme, may also take on more responsibility for meeting refugees' basic needs. So might the private sector or even "individual rich people". Mr Lubbers thinks "many companies would be very proud" to sponsor aid for refugees.

On the crucial question of whether the UNHCR will take on responsibility for the 25m or so people displaced within their own borders (and so not considered refugees under international law), Mr Lubbers is equally keen to limit his agency's duties. Such people, he says, are the responsibility of their own governments: "The UNHCR is taking care of people who don't have a state to take care of them." He would countenance help only if permission were granted by the host government, and if its effectiveness were not in doubt. That attititude is in stark contrast to that of his predecessor, Sadako Ogata, who wanted to help the internally displaced but said she did not have enough money. She had managed to expand the agency's remit to help Bosnia's internal refugees during the civil war of the 1990s.

But the most controversial topic on Mr Lubbers's agenda is the treatment of asylum-seekers in Europe. On this he promises a tough campaign to preserve asylum laws. "It is a real problem that Europeans try to lessen obligations to refugees. They must take seriously the responsibility of giving asylum." But his largest donors—the EU, America and individual European countries—resist that message. Mr Lubbers's desire to shame them into action will be tempered by the knowledge that they give the bulk of his budget.

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Egyptian politics

All snarled up

Jan 25th 2001 | CAIRO
From The Economist print edition

WHEN seatbelts were made mandatory in Egypt this month, Cairo's ageing taxi fleet quickly adapted. Its many clapped-out cars now feature a bold array of sham restraints to fool nosy policemen. "Who needs a real seatbelt when traffic barely moves anyway," grumbles one cabbie, after asking a passenger to drape a suggestive length of old luggage strap over his shoulder.

As with Cairo's stalled traffic, so with politics. Change in Egypt is glacial, and takes place against a backdrop of public apathy that is equally famous. Recent parliamentary polls, for example, returned the party that has run the country since elections began in the 1970s with yet another huge majority. But even the government admits, albeit with deliberate vagueness, that much less than half the electorate bothered to vote.

Yet just as Egypt's clogged roads still manage to be among the most deadly in the world, the country's surface political stagnation belies considerable turbulence. The election, which followed a seminal court ruling requiring judges to monitor polling booths, produced some surprises. Most of the candidates anointed by the government's National Democratic Party (NDP) failed to win seats. To make up its 85% majority in the 454-seat assembly, the party was obliged to enlist some 218 "independents", many of whom resent its failure to back them in the first place. The NDP's dismal performance has now prompted a behind-the-scenes effort to clean up the party's act.

The fractious and feeble opposition also scored gains, doubling its representation. Despite being officially banned, the Muslim Brotherhood emerged as the largest single opposition party, with 17 seats. The showing made by the Brothers, Egypt's oldest and most broadly-based Islamist group, was especially impressive considering that hundreds of activists had been rounded up before the voting and several of its candidates had suffered open harassment.

Having tried intimidation, the government now seems to be toying with accommodation. When an MP from the Brotherhood recently upbraided the minister of culture, Farouk Hosny, about some racy novels his ministry had published, Mr Hosny leapt to oblige by summarily banning the books and sacking the official deemed responsible. In response, most of the editors employed by the ministry, among them some of Egypt's most eminent writers, resigned in protest. The fury of Egypt's secular intellectuals was particularly sharp, since Mr Hosny had spoken up in defence of freedom of expression amid a similar fracas last year. He had even awarded one of the banned novels a literary prize.

The government is making other tactical concessions to religious conservatives. Egypt's interior ministry says it plans to reintroduce a law requiring wives to get their husband's approval before obtaining a passport. The overturning of this law last year was hailed as a breakthrough for women's rights. In an unusual move, the public prosecutor has reopened charges against a minor author, who was given a suspended sentence last year for writing atheist tracts. In the southern province of Sohag, meanwhile, police recently arrested of a group of Bahais, accusing them of heresy.

Such gimmicks are not new. Egypt's government often adopts Islamic postures to bolster its legitimacy. But just as Cairo's sham seatbelts will not save lives, the government may need more than gestures to convince an increasingly restless parliament and public that it knows where it is going.

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The party's over

Jan 25th 2001
From The Economist print edition

After a long corporate-borrowing binge in America, lenders are getting wary of shouldering ever-increasing risk, says Richard Cookson

BESIDE the extraordinary American economy, now in its tenth year of expansion, all else pales. Innovative technology has gushed from its research laboratories, boosting productivity and profits. So great has been America's allure that the country has been able to finance a current-account deficit of well over $1 billion a day. Lesser countries would have needed a cheaper currency to pull this off. But the dollar has seemed to defy gravity.

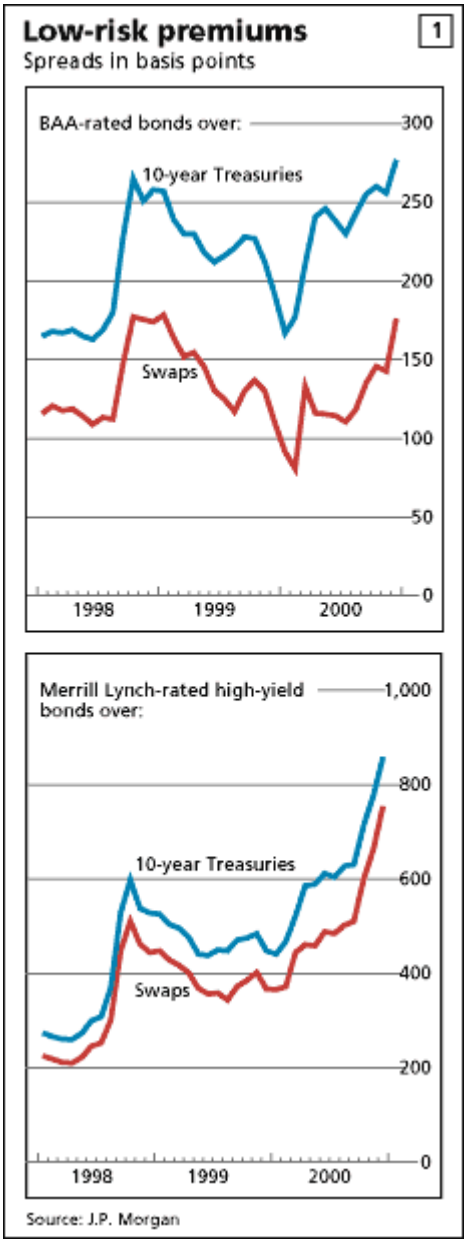
Until last year America's stockmarkets too, which had been climbing for 18 years with only brief interruptions, seemed to rise above Newton's immutable law. Then one by one the apples began to drop. Nasdaq, the repository of high-tech wonder stocks, breached 5,000 in March but dropped sharply thereafter. By the end of last year it had fallen by half from its peak. First came the Internet sector, where many shares plummeted by 90% or more. Telecoms and technology followed.

Still, share prices in general are still far higher than they were only a few years ago; it was, after all, only at the end of 1995 that the Dow Jones Industrial Average passed 5,000, less than half its level now. Oddly, however, although stockmarkets climbed after the crisis sparked by Russia's default in 1998, corporate-bond markets never quite recovered. In recent months they have been hammered. First the junk-bond market collapsed, then investors backed away from many investment-grade borrowers too.

The easy explanation for the corporate-bond markets' woes is that as governments—notably in America and Britain—have been running fiscal surpluses and issuing fewer bonds, so the yields of their ever-scarcer risk-free bonds have fallen relative to corporate bonds (see chart 1). But it is not as simple as that. Corporate bonds have, after all, also performed poorly compared with a less distorted benchmark: the London Interbank Offered Rate, known as LIBOR, the interest rate at which the best banks lend to one another.

There is always a tension between the owners of a firm and its creditors. Owners want to earn the best returns; creditors want their loans repaid with something extra to compensate for the risk of default. Until the 1980s, most companies put the interests of bondholders first. Having a top-notch credit rating was an article of faith. Since then corporate America has been downgraded, both intentionally and unintentionally, to the detriment of bondholders. Few companies now boast a top-notch credit rating. In recent years the exuberance of shareholders has been matched only by the pessimism of their bond counterparts.

After 1998 this dichotomy became glaring. Shares, especially the favoured few technology stars, shot ever upwards; but by the end of last year corporate-bond spreads were wider than they had been at the peak of the 1998 crisis. Bill Gross, the manager of PIMCO, far and away America's largest bond fund, even advised investors to avoid corporate bonds at all costs.



A borrower be

The roots of all this go back a long way, and to unexpected places. One important factor was an advance in financial theory. In 1958, two financial economists, Franco Modigliani and the late Merton Miller, demonstrated that, given a few assumptions (eg, no difference in tax treatment), the value of a firm was just the same whether it financed itself with debt or equity; the only difference it made was to the division of a firm's wealth among its different classes of investor.

In the real world, however, dividends are taxed, whereas interest payments are not. That makes debt a lot cheaper than equity. So it was a mystery, argued Messrs Modigliani and Miller in 1963, why firms did not finance themselves almost entirely with debt. Of course there are costs to debt financing (for example, the risks of bankruptcy), but the tax savings far outweigh them.

The second reason why companies preferred debt is because it had become easier to raise. Competition among suppliers of credit increased hugely. Banks used to be the kings of corporate finance; in recent years they have become the handmaidens. In the early 1970s, banks had three-quarters of the lending market in America; now they have less than half. Capital markets have ballooned: think, for example, of the development of the junk-bond and asset-backed market in the 1980s. Banks have also had to compete with other intermediaries, many of which have better ratings than the banks themselves, and are thus able to raise money—and lend—more cheaply. So banks have started to lend to much riskier borrowers to maintain their earnings.

Until recently, this increased competition meant that companies both big and small had unparalleled access to credit. Over the past 20 years, mutual funds, banks and other lenders have been trying to discover how low down the credit spectrum they can go, and how finely priced their lending can be.

“Corporations’ capital structures are in play as never before,” says Stephen Kealhofer, a partner at KMV, a credit-research firm.

The parlous state of the bond markets over the past couple of years suggests that lenders have now come up against those limits. Part of the explanation is the destructive effect on creditworthiness of rapidly changing technology, which makes bondholders wonder whether some companies will be around to pay them back their money. The current troubles of telecoms firms provide a good example.

But the bond markets’ woes also illustrate something else: the increasing conflict between shareholders and bondholders. Just when lenders were throwing their money around, companies were on a borrowing binge, not least because they had realised that debt was cheaper than equity, and decided that they could live with lower credit ratings.

So in recent years companies have been buying back their own shares in huge quantities. American firms, for example, have bought back a net $2.7 trillion-worth in the past five years. Many of these purchases are financed not with retained profits but with debt, thus increasing firms’ leverage and reducing their creditworthiness. By last November, Moody’s, a big credit-rating firm, had downgraded 36 companies during 2000 for buying back their shares—the same as the combined total for the previous three years.

Look lively

Not all of the reasons why many companies are buying back their shares with borrowed money are wholly laudable. The flip side of the boom in high-tech shares was that investors shunned anything which smacked of the old economy. Companies therefore felt they had to make themselves look more attractive either by going on a takeover spree, or by leveraging their balance sheets: having fewer shares improves earnings per share.

The urge to borrow has been exacerbated by the growing habit of handing out stock options as incentives to senior employees. These are supposed to align the interests of a firm’s managers and its shareholders, but in reality they do no such thing. Holders of options—unlike shareholders—have every reason to bet the firm, because they share in any upside but not in most of any downside. If things go wrong, they simply refrain from exercising their options.

Bond investors were the first to spot that all was not well. Banks have taken much longer; indeed, in the past two years, they have been filling the gap left by choosier bond investors. Only now that their bad loans have started to mount have they reined in their lending. Suddenly credit is no longer so cheap and plentiful; instead, America is seeing the first signs of a credit crunch. This does not bode well for the country’s stockmarkets, which have already come off their highs.

This survey will concentrate on America, which has the biggest, most liquid and most sophisticated capital markets in the world, though there will be a few diversions elsewhere. But first, a quick look at the theory that has been partly responsible for the present fright.

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Debt is good for you

Jan 25th 2001
From The Economist print edition

Or so the theorists say

EVER since Franco Modigliani and Merton Miller published their famous papers on the relative merits of debt and equity financing, the central question in corporate finance has been about the optimal balance between the two. Remember that Messrs Modigliani and Miller argued that, given certain assumptions, the proportions of debt and equity capital were irrelevant to the value of a firm; the only difference they made was to the distribution of the spoils between creditors and shareholders. This was because the more debt a firm issued for a given level of equity, the riskier that firm became. Leverage increases the expected return to shareholders, but it also increases their risks. In an efficient stockmarket, the two should cancel each other out.

But a later, modified version of the Modigliani-Miller theory said something rather different. It allowed for the fact that the original assumptions, particularly on taxation, might not apply. In America, dividends are paid out of companies' net-of-tax income, and are then taxed again in the hands of the recipients. Interest payments on debt, on the other hand, are tax-deductible. This means that a firm's overall value should increase as it substitutes debt for equity, and suggests that many firms in the 1950s and 1960s had too much equity and not enough debt. However, it is clear that over the past couple of decades they have been trying to rectify that.

But not, perhaps, as vigorously as might be expected. As Mr Miller cheerfully conceded, his and his colleague's proposition implied that firms should be financed almost entirely with debt. Yet many big companies still think that their weighted average cost of capital—the total mix of debt and equity—would be cheaper in the long term if they maintained a solid credit rating.

Clearly, piling up more debt benefits shareholders only up to a point. That point, roughly speaking, is reached when bondholders are so worried about the company defaulting that the cost of its debt rises to unsustainable levels. To go on borrowing beyond that point may even lead to bankruptcy—though note that bankruptcy in America is rather less onerous to shareholders than it is in many other big economies. Moreover, inflation, both in America and elsewhere, is much less of a problem than it was in the 1970s and early 1980s, so interest rates are lower and companies can afford to borrow more. Some commentators, notably Stern Stewart, a consultancy that does a lot of work in this area, maintain that many firms still have too little debt. Mature, profitable firms, with the least need to borrow, probably benefit most from doing so. Bond markets are a harsh task-master: that interest has to be paid.

A matter of degree

Two other theories try to explain why firms are still reluctant to incur debt, or at least do not borrow as much as implied by the Modigliani-Miller theory. The first, called the trade-off theory, says that the amount of debt a firm is willing to take on depends, among other things, on the business it is in. Profitable companies with stable cashflows and safe, tangible assets can afford more debt; unprofitable, risky ones with intangible assets, rather less. So dot.com companies, to take a formerly fashionable sector, would be ill-advised to shoulder any debt at all. Firms in highly cyclical industries, such as car making, should probably be wary of taking on too much. By contrast, utilities, whose business tends to be more predictable, can afford much greater leverage.

Managers prefer this kind of theory to the Modigliani-Miller one because it does not imply categorically that they are doing the wrong thing. But does it give them much guidance on what, in fact, they should be doing? Some would argue that in a way it does; that firms "target" a credit rating they are happy with—according to the business they are in—and stick to it. Rick Escherich, an analyst at J.P. Morgan, has looked at a sample of 50 companies taken from *Fortune* magazine's list of "most admired companies", and found that only four of them have been downgraded by more than one notch over the past ten years. Most of them have the same rating now as they did a decade ago.

But Stephen Kealhofer of KMV says that, according to his firm's research, firms do not target credit ratings, indeed quite the opposite: "We find that firms engage in anti-targeting behaviour." Generally, they are more interested in their business plans than in what the rating agencies say. If they get into trouble, they increase their liabilities to enable them to carry out these plans, as the telecoms firms have done. "Only when they get close to default do they reduce them," he points out.

Mr Kealhofer prefers a third explanation of firms' behaviour, dubbed "the pecking-order theory". The central plank of this theory, first propounded by Stewart Meyers in 1984, is that outside investors in a firm know less about the health of a firm than its managers do. That can be a problem when the company wants to issue equity: investors may believe, rightly or wrongly, that the company is doing this because it thinks its shares are overpriced, and may respond by selling them. Issuing debt generally has a much less dramatic effect, but external finance is still costly. That is why the vast majority of new capital raised by firms comes from retained profits.

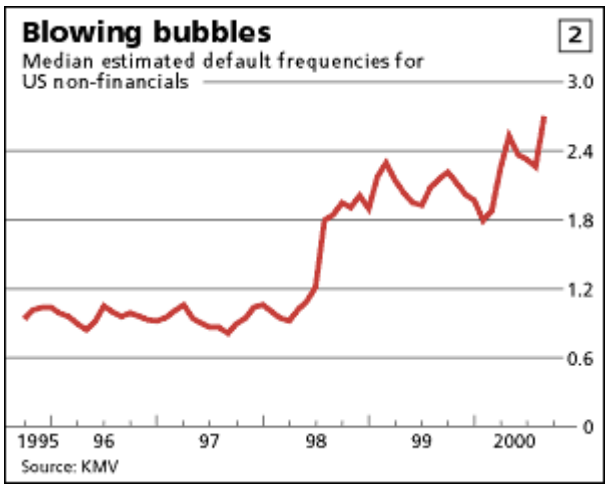
The pecking-order theory might help to explain why many big firms hold large cash reserves. If they find that these are insufficient, they often take another route: to delay paying their bills. In effect, when they need to borrow, the first place they look to is their trade creditors. Only when that route becomes difficult do they turn to external lenders—ie, banks or the bond market—and only as a last resort to the equity markets. That helps to explain why companies with stable profits often borrow a lot less than unprofitable ones.

Yet none of these theories gives much of a clue to whether, at any particular point, firms' debts are too high or too low. To put it another way, they do not tell you what the market thinks of a firm's default risk. For that, turn to another theory, which despite its less-than-snappy title has lately proved remarkably powerful: contingent claims analysis. This was first developed by Robert Merton, an economist who in 1997 won a Nobel prize with Myron Scholes for his work on developing mathematical models to price options (a third collaborator, Fischer Black, had already died). It uses option theory to analyse the differing claims that debtholders and shareholders have on a firm. The theory says that shareholders essentially own a call option on the firm (the right but not the obligation to buy). Shareholders get all the upside; their downside, thanks to limited liability, is restricted to the firm going bankrupt. The position of bondholders, by contrast, is that of someone having sold a put option (the right to sell) to shareholders, conferring on them the right to bankrupt the firm. The bondholders' main upside is the fee they receive for that option, ie, the interest on the loans they make to the firm.

Making money by default

The theory is helpful in analysing the market's view of a company's creditworthiness: the more likely it thinks a firm is to default, the greater the fee—ie, the higher the interest—it will charge. KMV has built a business applying this theory to estimate the likelihood of a firm defaulting. Some investment banks are increasingly turning to it. Even Moody's has developed its own version.

KMV's model has three main elements: how much a firm owes; how valuable the business is (using the equity price as an indicator); and the volatility of that business (which can also be deduced from the equity price). Surprisingly, although the equity market did splendidly in 1999 and early last year, its median estimated default frequencies (EDFs, a measure of the likelihood of default) for the 10,000 North American companies tracked by the consultancy carried on rising (see chart 2). In recent months, they have risen still further, and some firms have done worse than others.



If that seems odd, consider a slightly more refined way of looking at the put option that debt holders have sold to shareholders. It is, in fact, a put option whose strike price is a long way below the current price of a firm's equity. As a firm's shares fall to a level where the equity price, and by extension the net assets of the firm, get close to a firm's liabilities, the firm is in increasing danger of becoming insolvent. That makes the put option worth a lot more, so the yield on the company's debts rises.

The share prices of most firms, particularly those with an investment grade, are nowhere near this level. But this is where a key feature of option pricing comes in. Option markets do not guess the direction that an asset's price is heading in; instead, they look at its volatility. The more volatile an asset, the greater the chance that an option written on it will be exercised. Put another way, the more volatile a share, the less happy bond investors will be to lend to it. If the firm's shares become so volatile that insolvency is at least possible, the yield demanded by debt holders will rise, perhaps dramatically.

There is a further wrinkle. When the bondholder sells the put option to a firm's shareholders, the strike price—at which the option can be exercised—is not set in stone; it is variable. That is, the managers of the firm could reduce debt (which is helpful for bondholders because, in effect, it reduces the strike price at which a company becomes insolvent); it could increase debt (the opposite); it could sell shares (good); or it could buy them back (bad). The point to note is that bondholders sell managers not only the right to bankrupt the firm, but also the right to alter the firm's capital structure. Arcane as all this might sound, it helps in understanding what has been happening in the corporate-bond market this past year or so.

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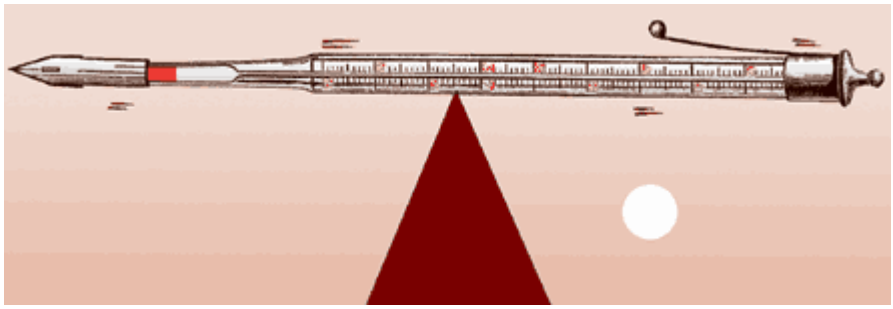
Bond blues

Jan 25th 2001
From The Economist print edition



America's corporate-bond market has reason to be depressed

FOR most of the past two years, America's corporate-bond market has looked positively capricious. Until recently, America's equity markets were soaring, fuelled by an economy that could seemingly do no wrong. By contrast, the corporate-bond market never really recovered from the tumult of autumn 1998, when Russia defaulted and a hedge fund, Long-Term Capital Management, had to be bailed out by its bankers. In recent months, the market has gone through an especially bad patch.

There seemed no rhyme or reason to this. The equity markets, which are supposed to represent a reasonable estimate of the future health of corporate profits and therefore of the economy, appeared to be predicting a cloudless horizon, yet the corporate-bond market seemed to be saying exactly the opposite: the spread of its yields over government bonds suggested a recession, as well as a looming credit crunch in some areas of the market.

Many previously solid credits were treated by investors as little more than pariahs; less secure ones were unceremoniously dumped. The woes of the junk-bond market are relatively easy to explain. The market had grown hugely, mainly because borrowers were able to get startlingly cheap finance from lenders. But that harked back to 1997-98, before the Russian crisis, when investors seemed to have lost sight of the relationship between risk and reward.

Since then the junk-bond market has been in steep decline. By last autumn only about 60 out of a total of 3,000 issuers were prepared to quote prices of a sort for their bonds, reckons Michael Lewitt of Harch Capital Management, a hedge fund. Some dealers took to quoting prices to investors as long as they did not want to deal in them, which did not inspire much confidence in the accuracy of the quotes. Some think that the value of junk portfolios is still overstated by anything up to 20%.

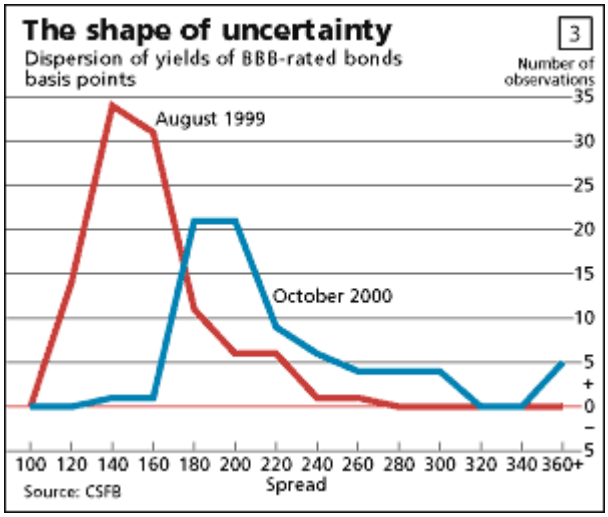
The returns that investors could get from such bonds were measly. In the late 1980s, at the height of the most recent junk-bond boom, investors' rewards for taking risk were high coupons and warrants that allowed them to buy the issuer's equity. In the late 1990s, by contrast, they were given paltry coupons and no equity inducements at all.

Moreover, the quality of those companies that had tapped the market was startlingly poor. The overwhelming majority of the issuers were in cyclical industries or in telecoms; half were rated B or less, Mr Lewitt points out. And some 80% of new issues were private placements for which the investment bankers that brought the deal to the market were not able to do much due diligence.

Of late, credit quality has been getting even worse. John Lonski of Moody's points out that the ratio of upgrades to downgrades is the worst since 1989—ie, just before the last recession. Moody's now expects the default rate to exceed 9% in the next year or so, assuming there is no recession. Investors have woken up to these risks and want to be compensated for them. Yields may have to reach about 20% before investors start to nibble, says Mr Lewitt. Since junk bonds are, to all intents, equity, investors feel they should offer equity-like returns.

No one is safe

The bear market in junk has now spread to some investment-grade credits too. Investors lament that they have had little or no warning from the rating agencies of a series of explosions that have rocked that market. So they are increasingly ignoring the agencies' assessments: the dispersion of yields around individual ratings is wider than ever before (see chart 3).



Xerox, a troubled copier maker, offers a good example of the woes of formerly solid credits. In October, after six profit warnings, its bonds collapsed, but the rating agencies continued to think it worthy of an investment grade. In one day, the spread of its bonds over LIBOR rose from 250 basis points (hundredths of a percentage point) to almost 450 basis points. Only at the beginning of December did Moody's bow to the inevitable and downgrade the firm to junk.

With variations, many other companies have the same story to tell. Retailers (J.C. Penney and Home Depot), funeral parlours, toy makers (Mattel), cinema chains, tyres (Goodyear) and, last but not least, telecoms firms (see article): the list of once-healthy borrowers now shunned by bond investors is lengthening.

Discouraged by poor performance, and encouraged by stellar returns from equity funds, retail investors stampeded out of bond mutual funds. Jim Bianco, who runs an eponymous research firm, estimates that, in the 12 months to November last year, inflows into all mutual funds amounted to about $240 billion. That was roughly the same as in 1993, but with one vital difference: in that year bond funds received roughly half of the money, whereas last year inflows into equity funds amounted to some $340 billion and outflows from bond funds to $100 billion.

The companies wanting to tap the bond market were not generally the same as those driving the equity market. Issuers with an investment grade are almost invariably the stars of yesteryear; it takes years of profits to be awarded such ratings. The companies that had been pushing up the stockmarkets in recent years generally had little debt. But in the quest to make themselves more attractive, those who were shunned resorted to leveraging their balance sheets by buying back their equity.

There are some aspects of corporate finance on which reasonable people can agree, but measurement of a company's leverage—the amount of debt that it has in relation to its equity—does not seem to be one of them. But it is important. Other things being equal, the higher a firm's debt-to-equity ratio, the greater the chances of it defaulting.

In theory, a glance at a company's accounts should give a fair idea of its equity and debt position. Measuring debt is the easier of the two: firms usually have to pay back money they have borrowed on a set date, so measuring such debt at book value is uncontroversial. Equity is more problematic, because it is not repayable. Sober sorts, such as the rating agencies, look at the book value of that equity and ignore the value that the market attaches to it. As Moody's Mr Lonski explains, to do otherwise would give firms a big incentive to issue debt to buy back their shares.

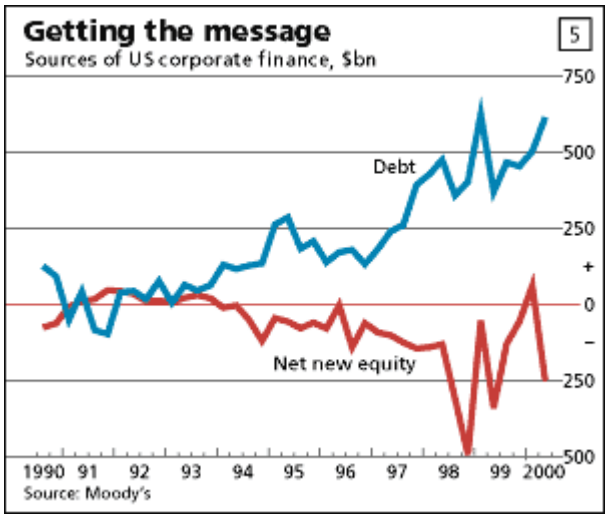
Furthermore, putting a market value on a company's equity puts leverage ratios at the mercy of the

stockmarket. The leverage ratios for junk bonds put out in the 1980s by Drexel Burnham Lambert, an investment bank, used market values, points out Jim Grant, editor of *Grant's Interest Rate Observer*. Perhaps unwisely, Drexel called them Market Adjusted Debt ratios (try the acronym). Certainly the subsequent sharp rise in defaults suggests that this was the wrong measure to use.

And yet, say defenders of using market value, the best guess of the worth of a company's equity is contained in the stockmarket; what it originally cost is irrelevant. Companies can, after all, tap the equity market at roughly the price that the company's shares trade at. And historic-cost or book-value accounting can be used as a cover for all manner of financial shenanigans.

The debate is of more than academic interest. In book terms, corporate leverage for America's non-financial firms rose from 70% in 1997 to 83% in the second quarter of 2000 (and that last figure would have been a lot higher still at an annual rate). For the 50 "admired" companies tracked by Mr Escherich at J.P. Morgan, leverage in book terms climbed, on average, from 19% in 1982 to 28% in 1999; in market terms, it fell from 13% to 5% over the same period. Doubtless, the stockmarket carnage of the past few months has increased that figure. But the point still stands: by market value, leverage seems to have declined, at least for the firms tracked by Mr Escherich.

This seems surprising. In recent years American companies have been the biggest buyers of their own shares. Chart 5 shows how net new equity has declined and debt has risen over the past five years or so.



America's M&A boom has not been paid for entirely with stock: American companies are also raising debt to spend on other companies' shares. Of late, they have been buying companies at the rate of $50 billion a month, compared with about $10 billion a month in the early 1990s, says Steve Zamsky, a strategist at Morgan Stanley Dean Witter.

Perhaps, argues KMV's Mr Kealhofer, the figures produced by Mr Escherich are incomplete. They do not include borrowing that comes from outside the market, such as delaying payment to trade creditors. This has a big effect on the leverage as measured by market value. But higher borrowing is only one reason for bond investors' doubts. They also worry about how well the businesses are doing, and how volatile they are, both of which are reflected in the share price. Although overall stockmarket indices are higher than they were in 1998, the shares of about 70% of quoted companies have dropped, some of them sharply. Firms that saw their shares hammered, apart from Xerox, include Eastman Kodak, Goodyear, Procter & Gamble, and most of the retailing sector, as well as some of the more elderly high-tech firms, such as Dell, Intel, Apple, IBM, and just about the entire telecoms sector.

And worse may be in store, for the volatility of some firms' shares has soared, which implies, in effect, that investors are more worried about their prospects. Again, the overall volatility of the stockmarket does not show up the more extreme examples. The implied volatility (the market's best guess about future volatility) on Xerox climbed from 25% to 70%, and that of Corus, once known as British Steel, doubled, to 60%. Why?

Technological fix

One obvious answer is ever-faster technological change. It may well be that the recent changes in information technology, for example, will ultimately prove less important than the invention of the telephone, the telegraph, trains, cars, or the spinning jenny; but they are undoubtedly happening more quickly. Computers are a lot more powerful than they were, and getting ever more so. The ubiquitous Palm Pilot has more computing power than a desktop computer did ten years ago. Rapid technological change is reflected in the rate of depreciation in America, which has doubled over the past 30 years.

That means companies will have to invest at a higher rate than in the past, says Paul Donovan, an economist at UBS Warburg. If their technologies are new, and untested, most of them are probably unprofitable. They will therefore have to turn to the capital markets and take on debt (remember that most companies dislike issuing equity). “It is safe to assume that in aggregate the new economy will entail a permanently higher rate of borrowing from the corporate-bond market,” says Mr Donovan.

But the most important effect of technological change on corporate debt is that rapid creative destruction is, almost by definition, destructive for debt holders. The faster technology changes, the less likely a company is to generate stable cashflows. When Xerox lost its way in the copier market, investors fled. The Internet and e-tailers may have had a nugatory effect on most of the high street, but their effect on profits has been huge at the margin; witness the problems at J.C. Penney and other retailers.

Telecoms provide a splendid example with a subtle twist. First there were fixed-line telecom companies. Then came deregulation and the mobile phone, not to mention other ways of delivering telephone services, such as the Internet. All this has eaten into traditional telecom firms’ revenues. In Europe, they decided to bet on the Internet. Hence the huge sums that they have invested in 3G licences, in the knowledge that they will have to spend almost as much again on the infrastructure.

But they probably had little choice. Such was the stockmarket’s fascination with the Internet that, had they not invested such large amounts in 3G licences, they would have been punished by a steep drop in their shares. And that, in the conditions prevailing until the middle of last year, would have meant being taken over.

Bond investors, with little upside from the risks taken by companies’ management, have taken fright at rapid technological change, increased leverage and the risks posed by a surge in mergers and acquisitions. When all was going swimmingly, shareholders did not care. Now that America’s economy and corporate profitability are slowing, they have had second thoughts. Those fears have been compounded by the dawning realisation that many parts of the American stockmarket were absurdly overvalued.

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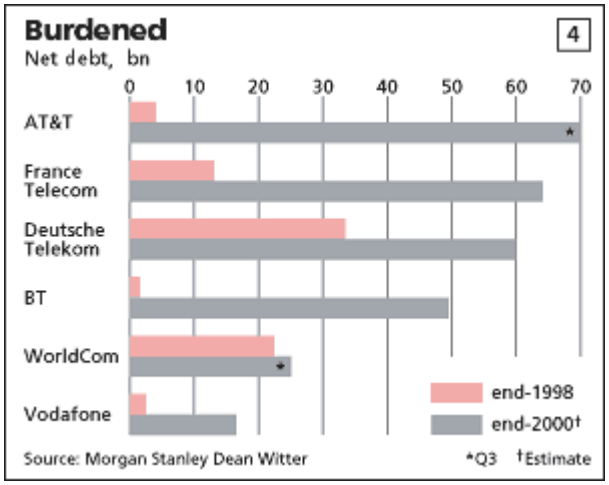
A $250 billion gamble

Jan 25th 2001
From The Economist print edition

The telecom sector has overreached itself

EUROPEAN telecoms shares have suffered something of a bloodbath. The reason is clear: such firms have spent huge amounts of money on so-called 3G (third-generation) licences from various European governments, which they felt they needed, among other things, to enable them to offer Internet access from mobile phones.

The sums they have spent on these licences may well turn out to be the largest investment in the shortest time by any sector in history. The final tally is yet to come, but they already know that whatever they spend on the licences, they will have to shell out almost the same again on building the infrastructure. Pessimists feared that the whole thing might add up to around $300 billion, but a few recent auctions have flopped, so the final total may come to somewhat less than that—perhaps $250 billion.



Telecom firms' debts have shot up, and their leverage with it (see chart 4). Britain's BT, for example, at the end of 1998 had debts of $1.5 billion. Now those have risen to $30 billion, sending its debt-to-equity ratio soaring to 190%. As with BT, so with many other telecom firms (although Vodafone and Telefonica are in rather better shape). Investors fret that nobody really knows whether consumers will want to use their mobile phones to surf the Internet; and even if they do, competition will be so fierce that nobody will make any money.

To get their huge debts under control, telecom companies will have to sell assets and partially privatise some of their more valuable operations. But they may not raise as much money as they had hoped, if only because the operations they want to float have become a lot less valuable than they were. Telecom shares have dropped by 50% since their high in March; the more exotic examples, such as Internet-service providers, by far more.

So telecom firms have had to turn to bond investors and banks (which sometimes amounts to the same thing); but those potential saviours have become more reluctant. Although the main rating agencies still award big European telecom firms an investment-grade rating, some sophisticated investors think that they are now little better than junk. Banks are already up to their necks in telecom debt and do not want to take on more, if only because regulators are urging them to reduce their exposures. So telecom companies are having to pay much more for their capital, and to offer extra inducements, such as guarantees that, if they are downgraded, they will increase the coupon on their bonds.

But it is not just the European telecoms companies that are in trouble. WorldCom, Sprint, and AT&T,

America's three large long-distance carriers, have all been downgraded too, and America started to auction its 3G licences only last December. Deregulation has led to a huge increase in competition: there are now over 500 long-distance carriers in America. Profits are falling fast. To make up this shortfall, they have tried to get into other areas, such as mobile phones, and to get economies of scale through mergers. Financial markets are worried that firms' profits from their traditional businesses are falling more rapidly than they were, and that profits from new ones are rising more slowly. The markets are also bothered by the huge debts that the companies have incurred. With $62 billion of debt, it is small wonder that AT&T, which only a couple of years ago had a AA rating, is now only a notch above junk.

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Shareholder value

Jan 25th 2001
From The Economist print edition

How can you tell what a company is worth?

IT IS painfully clear by now that at least one part of America's stockmarket (and the same bit in Europe, Japan and just about anywhere else) was rather generously valued until the first few months of last year. Shares in TMT (technology, media and telecoms), that paradigm-shifting, blockbuster sector, have fallen spectacularly. Microsoft, Lucent, Dell, Intel, Toshiba, NEC, to name but a few: all have seen their share prices drop through the floor. Nasdaq, chock-a-block with technical wizardry, which had racked up gains of 85% in 1999, had a rather less joyous experience last year: it fell by 39% over the year, and by 51% from its high in March.

Don't even ask about Internet shares, which have plunged. An index of Internet stocks compiled by Goldman Sachs has fallen by 75% since March of last year. Companies such as Pets.com, Boo.com and all too many others have had to close their virtual doors. Helpfully, there is another Internet company, outspokenly entitled fuckedcompany.com, that lists many of those that have gone out of business or are in severe difficulties. A lucky few have managed to raise new cash, but many of these have had to become less virtual in the process. Amazon discovered that it had to build more warehouses; Britain's lastminute.com, a fancily packaged online travel agency with paltry revenues and a drooping share price, is to send out brochures.

For all the recent hype about shareholder value, almost no value for shareholders has been created by pure Internet companies—except for the lucky few who managed to get out in time. More fundamentally, for all the corporate-finance theorists' efforts to find a rigorous method of pricing equity, such attempts seem to have failed, or there would have been no bubble. And now there are worries that the TMT bubble may have distorted the way in which older companies have organised their balance sheets.

Technological innovation has always encouraged the formation of bubbles, a phenomenon that has been charted by Robert Shiller, an American economist, in a recent book, "Irrational Exuberance" (Princeton University Press, 2000). At the turn of the 20th century the stockmarket was transfixed by new technology. "Guglielmo Marconi made the first transatlantic radio transmission in 1901, and there were predictions that we would soon be in radio communication with the planet Mars," writes Mr Shiller. The stockmarket rose to ever giddier heights. There was also lots of talk of mergers, he points out, which was

good for share prices. Alas, in 1907 the market crashed spectacularly, and was rescued only by the intervention of J. Pierpont Morgan, the grand old man of American banking.

In the 1920s, Mr Shiller relates, electricity became widespread. By 1929, 20m American households were wired, almost half of these had vacuum cleaners, and a third washing machines. John Moody, the founder of the rating agency that bears his name, wrote glowingly in 1928: “In fact, a new age is taking form throughout the entire civilised world; civilisation is taking on new aspects. We are only now starting to realise, perhaps, that this modern, mechanistic civilisation in which we live is now in the process of perfecting itself.”

Another century, another technology, but the basic message remains the same: fundamental innovations rarely make shareholders rich in the long term. There is no reason to think that the Internet, and the firms that try to make a living from it, will do better for shareholders than the railways or the airlines did in their time. In fact, there is good reason to think that they may do worse, because the barriers to entry are so low. The only thing that might give an Internet firm an edge is the power of its brand. That is why so much attention has been focused on Amazon, which almost uniquely, though very expensively, seems to be building one.

Corporate-finance theory, you might have thought, would have had something to say about some of the absurd valuations in the Internet and high-tech sector. Investors seemed to be throwing cheap or free money at many such firms even though the chances of any profits in the foreseeable future were minimal.

Since equity is riskier than, say, Treasury bonds (on which you get your money back when they mature), the returns for shareholders—and thus the cost of equity for firms—normally need to be bigger. The greater the risk, the bigger the return needs to be. That would suggest that Internet companies should have found equity very expensive.

What do you earn?

One way of looking at this is through a company’s price-to-earnings ratio, or its reciprocal, the earnings yield. Shares with high p/es (or low earnings yields) are valued more highly because investors believe that they will deliver better returns. Those returns can come from income, capital gains, or both. Firms might choose to reinvest all of their profits in their business, which means that all of the returns to shareholders will be in the form of capital gains. But eventually, to be worth anything, the equity has to deliver money to shareholders, either through dividends or share repurchases.

Yet the expectations built into America’s stockmarket in general and the high-tech companies in particular were extravagantly optimistic, not least because some of the newest, brightest stars had no earnings, and therefore nothing to measure their performance by. No matter, said the boosters: in time there will be earnings, and lots of them. In the meantime, look at their price-to-revenue ratios. In fact, those looked pretty scary, too. But many people seemed convinced that anything with a dot.com after its name would do brilliantly.

The Capital Asset Pricing Model (CAPM) offers a more rigorous approach to gauging the cost of equity. It compares the overall extra riskiness of equities and the extra riskiness of individual shares with a riskless investment (such as Treasury bonds). The overall extra riskiness is captured by the so-called equity-risk premium. The extra risk for each individual security, called its beta, is compared with the market as a whole (in a portfolio, some risks net out: one share might go up at the same time as another goes down). On this view, shares that offer higher returns than the risks that investors are willing to take are cheap; those with lower returns are expensive. So the cost of equity is defined as the risk-free rate plus the share’s beta multiplied by the expected equity-risk premium.

That sounds reasonable enough, but there are one or two problems with it. Many stockmarket boosters argue that the equity-risk premium has fallen because investors have realised that, over time, stocks are not as risky as they had thought. But as Mr Shiller points out, such arguments were already being trumpeted back in the 1920s. And anyone who invested in, say, Japanese shares over the past decade is unlikely to be convinced.

Then there is the problem about how volatility should be measured. Investors have to base their forecasts of a share’s future volatility on its performance in the past, but they are only guessing. As the experience of the past couple of years shows, companies with hitherto fairly stable share prices can

become very volatile indeed.

That leads to the third problem: is volatility the same as risk? Only up to a point. One difficulty is that as shares fall, their beta generally rises. If that happens, investors will not buy them even though they are cheaper, and thus presumably less risky.

But the main trouble with CAPM is that it is a static, backward-looking theory. Investors generally want to buy into those areas that grow fastest, because they hope that the returns will be juicier. One risk for them is in not being invested in these stocks. Volatility does not really enter the equation: new firms are, by definition, too young for it to matter. "It's like asking how big a baby will be when it grows up," says Bob Gumerlock, a risk consultant. So it is no surprise that investors rushed into high-tech firms even though the volatility of their shares was many times that of their old-economy counterparts.

Into the unknown

But they are still uncertain over how to square traditional notions of value with extraordinary growth rates and unusual profits (or lack of them). Had they gone by the book, investors would not have touched high-growth, loss-making companies with a bargepole. Investors have to take a view on how fast a company will grow in the future, bearing in mind that even the headiest growth rate has to slow down eventually. But in the end it still comes down to a decision whether to buy or not to buy. If they decide to buy, investors may drive up the price of a share in short supply, thus providing the company with cheap or, in effect, free capital.

Theories have their limits. Harch Capital Management's Mr Lewitt puts it bluntly: "It's just dressed-up rampant speculation. There's no way to value these things."

But while everyone was merrily speculating on apparently high-flying growth companies, the more old-fashioned companies that actually produce profits found themselves shunned by the stockmarket. Many of them dressed themselves up as growth stocks to get back into favour. They added the dot.com suffix to their names or gave themselves modish monikers. Ray Soifer, a banking consultant, tells the story of a company he bought shares in, California Microwave, a maker of telecoms equipment. The shares languished at a few dollars each until 1999, when the firm changed its name to Adaptive Broadband. Its shares climbed to $100. But nothing else changed, and now the shares are back where they started.

Others tried more substantial remedies; in particular, they cast around for mergers and acquisitions. Naturally they put forward the best of reasons: cutting costs, building scale, acquiring technologies. But they also knew that nothing sets the pulse racing like a big merger. A few worked; many others didn't.

Another sure-fire tactic for old-fashioned companies to boost their appeal was to use borrowed money to buy back their own shares. On paper, that increased their earnings per share, though not, of course, their underlying profitability (return on capital).

For all the talk about radical restructuring, flexible labour markets, and the miraculous effects of new technology, the truth is that American companies' underlying profitability has not increased that much. Smithers & Co., an economic-research outfit that has been a perennial scourge of bulls everywhere, has crunched the numbers and produced some striking results. Since 1991, the return on equity for American companies has risen by a spectacular 108%, and is now some 30% above its long-term average. Their return on capital (before depreciation, interest and tax), on the other hand, has risen by a much less spectacular 13%, and is now back to its long-run average of just under 9%. Much of the higher return on equity was due to greater leverage and, oddly (in the absence of corporate-tax cuts), lower taxes.

It would be hard to argue that all this was done exclusively in the interests of shareholders. The same is true, with even greater force, of the way in which American companies' managers are paid.

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Called to account

Jan 25th 2001
From The Economist print edition

Stock options and pooling can damage shareholders' wallets

"THERE is no rationale for not treating stock options as an expense. Except that if you did, it would have a greater impact than Greenspan resigning, the election and another financial crisis rolled into one." Thus a senior figure at a large investment bank, many of whose high-tech clients pay their people mostly in options. Why such a big impact? Because it would trigger a huge fall in corporate profits and individual wealth.

Stock options are controversial in all sorts of ways, not just because of their accounting treatment. Start with the reason why they are granted to a firm's employees in the first place. The idea is that they align the interests of managers with those of their shareholders. Handing options to managers, the theory goes, means that they will want to see share prices rise, just as shareholders do.

Given the vast sums that managers make from stock options, it is a little surprising to find that companies which grant options do not appear to perform any better than those that do not. According to a study by Harvard Business School, "Results indicate that no aspect of a company's pay-plan design predicts the company's performance." Instead, "The primary reason for linking executive pay to performance may be to provide 'cover' for huge payouts to senior management."

In fact, it is possible to argue that share options provide an incentive to managers that is diametrically opposed to the long-term interests of shareholders. The main reason is that stock options leave recipients free to buy or not to buy. If things go swimmingly, they will; if something goes wrong, they are free to pass, whereas shareholders may have to sell at a loss. Managers with options thus have every incentive to shoot for the moon—especially if the remuneration committee reprices the options when a company's shares fall sharply, a practice that the Financial Accounting Standards Board (FASB) is trying to clamp down on. Regardless of whether they provide the right sort of incentive, companies are dishing out options ever more willingly. Of 350 companies surveyed by William Mercer, a consultancy, 93% reward their directors with stock incentives; in 1992, only 63% did.

Since stock options are used as a form of payment, it is hard to see why they should not be treated as an expense. Warren Buffett, a revered investor, famously asked: "If stock options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world do they go?"

All the facts seem to suggest that stock options should be included in the profit-and-loss account (called the income statement in America). They are issued every year. The tax authorities treat them as tax-deductible expenses. According to the rules, liabilities should be recorded in the year in which they are incurred. There is a robust way of pricing options, first developed in 1973 by two economists, Fischer Black and Myron Scholes. And a financial institution that sold options would invariably record and hedge them at the time when they are written. Yet the FASB ran into fierce opposition from Silicon Valley when it tried a few years ago to change the rules so that options would be treated as an expense. Why the fuss?

We can't afford it

The main argument advanced for not putting options into the profit-and-loss account is perfectly simple: to do so would cost American companies too much. "A number of technology companies—most of the

Silicon Valley companies—had company-wide option plans. For them the expenses would have been huge," says a member of the FASB. And Silicon Valley, it turned out, had more clout in Washington than the FASB.

The effects of not recording options on the profit-and-loss account are huge. Just look at Microsoft. From 1991 until June of last year, its outstanding shares increased from 4.2 billion to 5.3 billion. Over the same period it issued about 1.6 billion new shares under its share-option scheme and bought back 677m, which cost it $16.2 billion. That figure did not, at any time, appear as an expense in Microsoft's profit-and-loss account. Even so, the company was able to claim tax relief to the tune of $12 billion on the options that were exercised. Over the past three years, Microsoft has paid only $2.8 billion in taxes.

Smithers & Co., which has crunched the numbers for America's biggest companies, found that if options had been properly accounted for at the time when they were granted, the profits of large listed companies in 1998 would have been two-thirds lower. The recurring cost of options to American companies were they to be immunised would be about 20% of profits. As hardly any of them do immunise their stock-option programmes (by buying equal and offsetting options), and were therefore exposed to rising share prices, their true profits, on a full-cost accounting measure, were only 37% of those published, according to Smithers.

This is not fanciful stuff. A study by Nellie Liang and Steven Sharpe, two economists at the Federal Reserve, was quoted by the bank's boss, Alan Greenspan, in a speech to central bankers. It estimates that stock options have added, on average, 1.5% a year to the growth of corporate profits, and that they were worth 10.5% of stated profits in 1998, up from 4% of profits in 1994. Given the dramatic rise in the stockmarket in 1999, the figures were doubtless higher in that year. Moreover, the two economists point out, "Because the cost of employee stock-option grants generally is not accounted for in companies' income statements, their growing importance has also created distortions in earnings-based valuation measures such as price-earnings ratios."

However, the effect varies between industries. In IT, option costs amounted to about three times published net profits. According to Smithers, had Microsoft accounted for its options properly, in 1998 it would have made not a profit of $4.5 billion, as its accounts showed, but a loss of $17.8 billion.

So if options are a real expense, where does the money come from? The answer is: directly from the balance sheet, in one of two ways, both of which do tangible harm to shareholders. When employees exercise their share options, the company concerned can do one of two things. The first is to buy its own shares in the market. However, if it does, shareholders lose out: the cost to the company of buying its shares in the market is higher, sometimes much higher, than the price at which they must sell them to employees. There is "a wealth transfer from shareholders to employees, which will be especially large following periods of unusual stockmarket gains," write the two Federal Reserve economists.

Second, if companies do not buy their shares back, there is only one alternative: to issue more shares. This "dilutes" the holdings of existing shareholders; they end up owning a smaller proportion of a bigger pie. Moreover, if the number of shares rises, then to achieve the same earnings per share, companies must increase their profits more.

So stock options have a real, and large, economic effect. If they did not, says Jim Chanos, of Kynikos Associates, a hedge fund, "Why do people fight so hard to get them, and why did companies fight so hard in Congress?" After a long battle, in 1995 the FASB at last managed to get companies to include the options granted in the footnotes to their accounts. But as one of its members says: "Footnotes are unsatisfactory. They should go into the income statement." And the chances of that happening in the near future? "Zero," he replies.

Who said pyramid scheme?

There is another popular accounting device that has flattered companies' profits, again by apparently reducing costs: so-called "pooling of interest". Unlike stock options, however, pooling is likely to be scrapped early this year. Not before time, for pooling, too, produces some odd distortions and allows companies to mislead shareholders about their profitability.

There are two ways of accounting for the purchase of another company. The first is to use purchase accounting. If a company uses this method, it has to write off the goodwill—the difference between the purchase price and the assets of the acquired firm—over a period of years.

If, on the other hand, it uses pooling, goodwill is left out of the accounts altogether. All the company does is to record the cost of the acquired firm's assets. So if company A buys company B for $100m, and company B has only $5m in assets, only that $5m is recorded, even though $100m has actually been paid. The rest—$95m—does not appear on the balance sheet.

The incentive is clear enough: the return on the money invested appears to be much higher, because it is calculated on a much smaller base. But the effects can be bizarre. Take the above example. If company A then sells company B for $25m, under pooling, it would actually record a $20m profit rather than a $75m loss.

Cisco, that bellwether growth company, is one that sceptical accountants love to get their teeth into. There is no doubt that the company is growing. What is more doubtful, given its stock-option programme and its questionable use of pooling, is whether that growth benefits its shareholders. Abraham Briloff, a professor of accounting at Baruch College, New York, analysed the company for *Barron's*, a financial weekly. In the financial year that ended in July 2000, the firm bought 12 other companies at a cost of $16 billion, all of them paid for with its shares. Five of these purchases, worth some $1.2 billion (though showing up as a cost of $1m), were not thought important enough to have to restate its previous year's profits. The other seven, for which Cisco paid a total of $14.8 billion, were recorded as costing a mere $133m.

Thus, thanks to pooling, did $16 billion-worth of acquisitions turn into $134m-worth of costs. Moreover, argues Jim Grant of *Grant's Interest Rate Observer*, if the dilution for previous years had been correctly calculated, earnings per share would not have shown a rise from 29 cents to 36 cents, but, thanks partly to its prolific shares issuance, would have started and finished at 31 cents.

Silicon Valley, once again, has kicked up an almighty fuss about scrapping pooling, complaining that such a move would make it too costly to do deals. This time, however, the FASB seems to be holding firm, not least because it wants the costs of a takeover to be recorded accurately. "What is it really saying, that if I have to report the price I can't afford to do the deal?", asks one FASB member.

The effects of scrapping pooling are likely to be twofold. For a start, because pooling, like stock options, flatters reported profits, firms' managers will have to work harder to increase their earnings per share. Second, America's mergers-and-acquisitions boom will slow, perhaps dramatically. Shareholders should rejoice at both.

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A hazardous journey

Jan 25th 2001
From The Economist print edition

In pursuit of profits, banks are taking ever greater risks

THE rule for American bankers used to be simple: don't lend to anyone who needs the money. A few decades ago banks lent to rich people and to companies with an investment grade. Their profits were fairly stable, apart from the odd crisis, if only because their borrowing costs were fairly stable, too: deposit rates were fixed by regulation, and investors had precious few other places to put their money. So banks in those days carried much less risk than they do now for the same return.

Deregulation and increasingly sophisticated financial markets have changed that. Equity commissions were deregulated in 1975, and deposit-account interest rates in the early 1980s. Individuals can now pop their money into a vast array of savings vehicles. Companies with decent marks from the ratings agencies and, increasingly, those without, can borrow more cheaply from the capital markets, because banks have to set aside capital when they lend, because they have to pay taxes, and because some borrowers have better ratings than they do.

Having once shunned borrowers who appeared to carry the faintest whiff of risk, banks have recently had to branch out. Many of them have started to follow both their savers and their borrowers into the capital markets. They themselves now offer an array of savings products. For the affluent, they provide more value-added services, such as private banking. The bigger banks offer their corporate clients capital-market services. In effect, they have substituted fee businesses for balance-sheet risk.

Or at least they have tried to do so. In fact, fee business still accounts, on average, for only 40% of their profits; the rest comes from their lending business, which has become much riskier, for two reasons. For a start, banks have had to finance themselves with money that is both more volatile and more sensitive to credit risk. Given that banks' ratings have fallen steadily over the years, this means that their money has become more expensive. In 1978, the earliest year for which figures are available, some 21% of assets were financed by money from big companies and investors; now some 36% of their assets are financed by wholesale money. Cheap, stable finance is dwindling rapidly. In 1996, core deposits (savings accounts and so forth) financed 54% of banks' assets; in the third quarter of last year, the figure was 45%.

The banks are also taking more credit risk. In 1978, loans accounted for 55% of their assets; now the figure is 65%. But this figure disguises the amount of extra credit risk they have been taking, since better-quality borrowers have, in general, turned their backs on banks. In an effort to keep up their profits, banks now have many more retail assets such as mortgages and credit cards on their balance sheets.

Banks have also turned to less creditworthy corporate borrowers, and not just because better-quality borrowers have turned to the capital markets: other sources of loans with better credit ratings have undercut the banks, because they are able to borrow, and therefore lend, more cheaply. Even as banks' credit ratings have steadily fallen, companies such as GE Capital, which has a AAA rating and does not have to hold expensive regulatory capital, has much cheaper access to money, especially of the wholesale variety.

In the early 1970s banks had 75% of the lending market; now they have under 50%. Banks now compete mainly on lending to those borrowers that have a sub-investment-grade rating, or none at all. And compete they do, for their shareholders demand it. In the past four years, banks have made returns

on equity of some 16.5% a year, a better performance than ever before over such a long period. The question is whether they have been taking undue risk to generate these returns.

Being honest about their exposures is not in banks'—or rather their managers'—interest. They are deeply reluctant to charge off loans or put aside reserves to cover doubtful loans, because if they did the prudent thing by their shareholders their share prices would probably drop precipitously. That, in turn, would make them more likely to be taken over. "Think of the strategic vulnerability where market cap is the currency to do acquisitions. If I hide my problems, then I'll do better than a bank behaving sensibly," says David Gibbons, the head of credit risk at the Office of the Comptroller of the Currency, one of America's main bank regulators.

Banks can disguise their problems in myriad ways—which makes the 10.4% regulatory capital that American banks currently maintain against their risky lending (2.4 percentage points higher than the regulatory minimum) less comforting than it looks at first sight. First of all, there is the age-old banking device: giving the disabled a walking stick. Bond markets are ruthless in cutting out the incapable; bank loans, in contrast, are far more negotiable. Only if borrowers get into real trouble do banks generally admit that there is something wrong.

Trick or treat?

Then there is a host of financial trickery. Securitisation is one popular form. Banks take on loans of one sort or another and then sell them off, collecting fees for their trouble. This appears to move exposures off their balance sheets, but many regulators believe that the amount of risk which banks actually shift is tiny at best. The reason is that they keep the really problematic stuff, essentially equity, on their balance sheets. In theory they should write this off one-for-one against capital; in practice few do. The Basle Committee, which sets international rules on bank capital, is changing them to make the banks come clean.

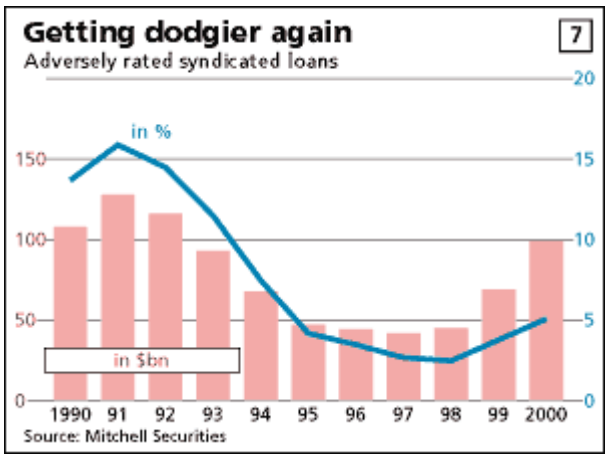
There are also off-balance-sheet exposures: things like guarantees and derivatives. Charles Peabody, a bank analyst at Mitchell Securities, draws attention to banks' derivative portfolios, and equity derivatives in particular. One of the biggest risks in derivative contracts is the risk that a counterparty will not pay up. This happened in both the Russian and Asian crises. The amounts involved are large: about three times capital for those banks involved in the derivatives business. So far credit losses in the derivatives business have been very small, but then the counterparties have generally been of very high quality. Competition in the business means that margins will be reduced, and the creditworthiness of counterparties with them, leading to bigger losses.

Banks' urge to take on ever more risk reached its zenith in the mid- to late 1990s, and especially after the 1998 crisis, when the capital markets dried up and banks stepped in. In 1998-99, loans to commercial and industrial companies grew by 8%, and in recent months at an annual rate of 10%, much faster than GDP. Lending to riskier credits increased sharply. Lending to sub-prime retail borrowers—those with a bad credit history—rocketed. So did lending to property companies and those with less-than-robust marks from the rating agencies.

More important, the money was cheap. In June 1997, just before the Russian crisis, the difference in spreads over LIBOR of AA syndicated loans compared with BB ones (junk) was only some 45 basis points. Risk, it is clear, was not well rewarded. In recent months pricing has become rather more rigorous, but banks still have many loans at razor-thin spreads on their books.

Despite banks' natural inclination to keep mum, it is clear that things have not been going well of late. One indication has been a big pick-up in defaults of junk borrowers. Moody's has recently increased its estimates, and now expects the default rate to increase to over 9% later this year.

Bad loans for banks themselves have also been rising, albeit from a low base. According to regulators, doubtful or bad loans in the syndicated-loan market alone climbed to $100 billion last year, a 70% increase on the year before, and only a little less than the $128 billion of dodgy syndicated loans on banks' books at the peak of the last recession (see chart 7).



That sounds a lot, but it still amounts to only about 5% of total syndicated lending. The trouble is that it is happening at a time when the economy has been fairly robust, if less so than before. Pessimists such as Mr Peabody argue that, if there were to be a recession, banks' bad loans would typically climb to 15% of the total—an eye-popping $300 billion.

Syndicated loans are the most visible source of potentially dodgy lending (although they account for a fifth of the $3.7 trillion lending market). Last June, Wachovia was the first to come clean by announcing some horrid bad-loan figures. Others have since followed. In November, Bank of America, the country's second-largest bank, said that it expected charge-offs for bad loans in the fourth quarter to double from the $435m it had reported in the third quarter. Come December, it was saying they might rise even faster—even if the economy did not go into a recession.

Perhaps some of this is the banking equivalent of a spot of blood-letting. Of that $100 billion of bad or doubtful syndicated loans last year, more than a third was leveraged lending (to sub-investment-grade borrowers). Possibly banks were getting rid of their worst loans, but it would be unwise to bet on it. A senior British banking regulator says that in telecoms, for example, in America a high proportion of lending is now to non-investment-grade companies, though for the moment most of British banks' lending is still to investment-grade borrowers. He worries, too, about the returns made by American banks, and about the nature of lending in America.

Mr Gibbons, too, frets about such things. "I wouldn't want to be a debt holder," he says. "All of the upside goes to shareholders." Many of the telecoms companies that are spending so heavily on mobile capacity "have never made a dime. Over the course of ten years they're still unprofitable because they still have to reinvest in and upgrade their infrastructure. At some point they will have to turn a profit, pay their debts and still have enough to invest. Otherwise somebody else will take their business away."

Once upon a time, banks lent to companies only as much as their assets were worth, but the value of many of their recent loans has greatly exceeded that limit. "To me, that's an equity risk," says Mr Gibbons. "Why would I make equity-like loans?" The answer, apparently, is a heady combination of high share prices, pressure to make profits, and a belief in the "new economy".

Banks' reserves are currently at their lowest since 1986, and in risk-adjusted terms at their lowest for 50 years, says Mike Mayo, a former bank analyst at Credit Suisse First Boston. In 1990, the OCC called in Wall Street's finest and told them they were being too optimistic about the state of America's banks. It then forced the Bank of New England to set aside huge reserves before shutting it down. Many big banks were burdened with huge quantities of bad loans, and bank failures climbed steeply. This time, all the OCC has done so far is to ask a few analysts to come in to talk about their inflated expectations. What might it do next?

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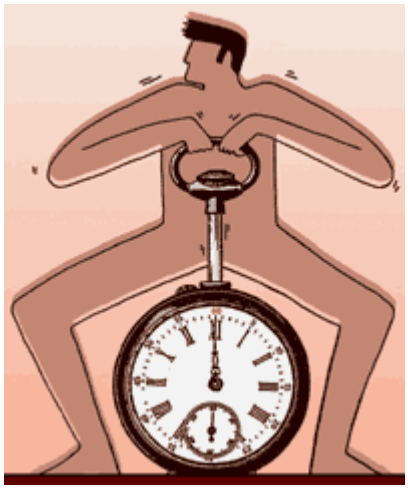
Destructive creation

Jan 25th 2001
From The Economist print edition

What happens when the good times come to an end?



IT IS a banking truism that the worst loans are made at the best of times. This survey has argued that, in America at least, companies' financing arrangements seem to assume that the good times will continue to roll. But all good things must come to an end. The American economy cannot continue to grow forever; indeed, it is starting to slow. Stockmarkets still appear to think that Mr Greenspan will perform yet another miracle, and keep the economy growing at just the right pace to keep inflationary pressures at bay without bringing it to a halt. Perhaps he will. But there is a risk, a big risk, that the excesses of boom times will make a bust more likely.

Although American companies are generally considered champions of shareholder value, there is ample evidence that they have not been acting in shareholders' long-term interests. Instead, they have been looking after their own short-term ones by forcing up share prices. For big companies, this has been a simple matter of buying back their own equity with borrowed money. That, of course, is precisely what corporate-finance theory has been telling them to do. Moreover, financial economists are forever griping that companies squander shareholders' money. So what could be better than to give it back? The strategy also has the virtue of making companies look more profitable. The biggest attraction of share buy-backs, however, is that they are likely to increase the value of stock options, which make up most of the remuneration of big-company bosses nowadays.

Stock options are fine for young companies to encourage workers to help the business grow, but for mature firms they are just a way of bilking shareholders. Whether they notice or not, they have to pay for the options, either out of shareholders' funds or by having their ownership diluted.

Similar scepticism is in order about mergers, which became ever more fashionable even though countless academic studies show that most of them destroy shareholder value. But if they do not achieve their stated aims, mergers do produce a couple of other desirable effects. First, the practice of pooling allows returns of the acquired company to be calculated from a small asset base, regardless of the actual cost of the purchase. And second, those precious options can be exercised prematurely.

Bond investors, rather late in the day, have started to realise that they are getting an even worse deal. They are exposed to most of shareholders' risks but get hardly any of the benefits. Rapid advances in technology make their position more perilous still. Creative destruction can be a wonderful thing for a few shareholders, but is bad for debt holders. Technological change is one reason why investors treat even some investment-grade bonds as lowly junk. Creditworthiness used to be determined by collateral; now, increasingly, it is determined by human capital, which is far more volatile.

There are two ways of looking at the reactions to all these events. On a charitable view, markets have been panicking needlessly, whereas credit-rating agencies, whose information is better than the markets', are being more sensible. On a less charitable view, though, the credit-rating agencies have been rather slow to adjust to changes in the real world. That, some reckon, is why Moody's (though not Standard & Poor's) has become much quicker to downgrade companies' debt.

Crunch time

The bottom line is that the markets have punished bond issuers far more than have the rating agencies. At long last, banks have started to do likewise. Many banks have had to ramp up lending to ever more risky credits so as to increase profits. Over the past couple of years, banks have gone where bond investors have feared to tread. Their lending has been growing at a giddy pace. Now they are beginning to discover the limits of that strategy. Their bad debts are increasing and may get worse, perhaps much worse. Bank of America, Wachovia and Bank One have all had to admit to big increases in bad loans, even in a strong economy. Now that the economy is slowing down, bank lending is likely to decelerate dramatically.

With both bond investors and banks keeping their hands in their pockets, companies' cost of borrowing will rise, perhaps steeply. The reason why bond yields have already risen so far is that there is more demand for finance than there are willing suppliers of it. That disproportion is likely to grow. In other words, America's present small credit crunch might develop into a big one.

If lenders are starting to worry so much, why not shareholders? The debt of Amazon.com (a well-worn example but a good one), with a market capitalisation of $6.3 billion, is rated only a touch above default. The company could come good; indeed, it is one of the few Internet firms that might. And there are sound reasons why shareholders would want to buy a company with bags of growth potential when bondholders do not: they get the upside, not the downside.

But the main reason why shareholders have been slow to realise that there could be trouble ahead is because nobody really knows how to value shares—except by the obvious means of seeing what people are willing to pay. Analysts do not have a clue either, although they pretend they do. And companies are equally ignorant about their cost of equity. If anybody had any idea of the "true" worth of equities, stockmarket bubbles would never arise. Yet another has just burst.

Quite probably, worse is to come. Companies have had to finance their investments and the servicing of their debts out of cashflow, which is starting to deteriorate. This is partly because the economy is slowing, and revenues with it, but also because many companies resorted to trickery to boost their revenues. Many high-tech companies have lent money to their buyers to purchase their products. Now some of those borrowers are finding it difficult to pay them back.

So far, stock options have helped the cashflow of many companies because they are treated as expenses by the tax authorities but not by the accounting ones. However, if share prices drop and options are not exercised, this boost to cashflow will be lost. That could be a big blow to companies such as Microsoft.

For many of the companies that pay their employees in options, a continued fall in their share price is likely to feed through into higher pay. If employees do not get their rewards from the stockmarket, they will demand more compensation up front. Higher expenses and falling revenues will put a big dent in earnings per share. Stockmarkets tend to get upset about such things. And if shares drop, companies' large debt burdens will be that much heavier.

Higher costs, along with lower spending on technology, would also presumably hit labour productivity. Much technology spending, and the availability of finance for it, was based on the assumption that economic growth would continue at its giddy rate of recent years. If such spending slows sharply, some, at least, of America's productivity miracle may quite possibly turn out to have been an illusion. The question then is how long will it take the American economy to unwind the excesses that it has built up.

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Jan 25th 2001
From The Economist print edition

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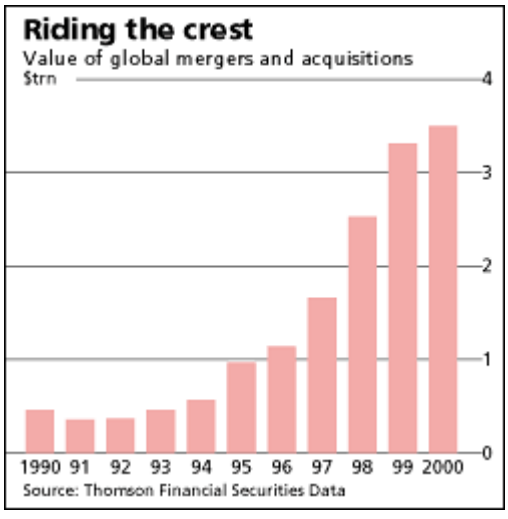
The great merger wave breaks

Jan 25th 2001 | FRANKFURT, NEW YORK AND PARIS
From The Economist print edition

The pace of mergers and acquisitions worldwide has slowed in recent months. Is the deal-making bonanza over, or merely pausing?

WHERE did all the mega-mergers go? It is now over a year since the most recent world-record-breaking corporate marriage was announced: AOL's purchase of Time Warner. Even the value of that deal, by the time it closed this month, was down by more than $80 billion from the day it was unveiled. In 2000, only one other merger was worth over $50 billion—of Glaxo Wellcome and SmithKline Beecham, announced a week after the AOL deal. Investment bankers are talking nostalgically about 1999, when seven mergers weighed in at more than $50 billion apiece.

The value of mergers and acquisitions (M&A) worldwide last year notched up yet another record: $3.5 trillion, up from $3.3 trillion in 1999 (see chart). But this headline number hides the fact that much of 2000's M&A activity came in the first half of the year, and particularly in the first quarter. The pace slowed markedly in the final quarter. According to J.P. Morgan Chase, only $63 billion of deals were announced in America in December, the smallest monthly total since the paralysing financial crisis of September 1998. Certainly, the outlook is now bad enough to justify asking if America's fifth merger wave—and perhaps the first truly global one—is on its last legs.



This prospect is starting to worry the investment bankers and lawyers who have come to find advising on mergers highly lucrative. One of New York's most influential merger lawyers, Martin Lipton of Wachtell, Lipton, Rosen & Katz, says he became convinced late last year that the M&A business was entering a significant downturn. Not only has the number of deals gone down; so also has the amount of talking about deals, a strong leading indicator of future activity.

There are several obvious causes of the decline in M&A. Share prices have fallen from the highs they reached early last year—in some cases, by a long way. This has reduced the attractiveness of corporate equity as a currency with which to pay for acquisitions. (At the height of the bull market in 2000, equity was the preferred method of payment in six out of every ten American mergers.) At the same time, for those buyers that want (or need) to pay in cash, the junk-bond market, a key source of finance for acquisitive companies, all but closed in the middle of last year (though it may now be reopening a bit, see article). Banks, under pressure from regulators, have also shut their doors to riskier borrowers.

These blows have fallen especially hard on the once hot technology, media and telecoms (TMT) sector. TMT accounted for over 40% of worldwide mergers in 2000, with deals valued at more than $1.5 trillion. Nobody expects 2001 to come close to that. TMT companies have been huge issuers of junk bonds and were among banks' riskier clients.

In theory, as the plummeting stockmarket has hurt TMT companies across the board, and thus mostly left the relative values of these firms much as before, it should not have made much difference to the appeal of a buyer's shares to the seller. In practice, company bosses—and shareholders—are not so logical. When the stockmarket is booming, managers are more emotionally ready to take big decisions. When the market is down, deals seem much riskier.

Moreover, buyers do not like to hand over shares which they think are worth a lot more than the market does, and sellers like to sell when their shares are at historic highs, says Rick Escherich of J.P. Morgan Chase. However unrealistic TMT prices were last spring, the fact that they are now much lower means that managers are unlikely to sell unless the buyer offers a big premium on the market price. It is only when bosses get used to their lower share prices, which may take a long time, that selling again seems palatable, says Mr Escherich.

The volatility of stockmarkets over the past year has only accentuated these problems. No manager wants to do a deal one day, only to find that the price has changed significantly the next. AOL Time Warner is a chilling reminder of the danger of accepting shares that promptly plunge in value.

Recent worries about the American economy heading for recession have also altered boardroom attitudes. At times of uncertainty, firms tend to focus on their core business, rather than explore possible new investments, such as an acquisition. Any revival of merger activity is likely to hinge on a rebound in economic optimism.

Europe had been expected to take a growing share of global M&A—especially by American investment banks and law firms, which have been building up their operations there—as its markets are more fragmented than America's, and big mergers are a relatively new phenomenon. But Europe has failed to pull its weight: M&A there accounted for a slightly smaller slice of the worldwide total in 2000 than in 1999, and it began to slow down sooner than in America. This was particularly true of European purchases of American firms—although these continue to dwarf American buys in Europe. The dire problems at DaimlerChrysler have made bosses think harder about the cultural challenges of cross-border mergers.

What, then, of all the talk that Vodafone's giant takeover of Mannesmann a year ago—the first successful hostile bid for a German firm by a foreign predator—would prise open the continent's markets for foreign bidders? If it then looked as if Europe Inc was up for grabs, it now looks more like a false start. The past year has seen a number of failed mergers—including two among Germany's big banks—and few big hostile bids. In fact, large European companies, such as Siemens and Vivendi, have been seeking to protect themselves from predators.

Gains to come

Even so, most investment bankers think the merger downturn in Europe will be temporary, not least because of pending reform to Germany's capital-gains tax, due to take effect next year. This should allow firms to sell their many stakes in each other tax-free, rather than facing a 50% levy, as now. Indeed, this imminent change may even have contributed to the slowdown in merger activity: why do a deal now when you can wait a year and do it more cheaply?

Europe's increasingly aggressive antitrust enforcement—symbolised by its blocking of WorldCom's planned $115 billion takeover of Sprint last June—may also be a growing deterrent to mergers. By contrast, in America antitrust may be moving in the opposite direction, with the new Bush administration expected to adopt a lighter touch than its predecessor. The appointment on January 22nd of Michael Powell to head the Federal Communications Commission may be a sign of things to come: as an ordinary FCC commissioner, Mr Powell voted against proposed restrictions on the merger of Time Warner and AOL (on whose board his father, Colin Powell, the new secretary of state, sat until last week).

Changes in the accounting treatment of mergers in America also point to an increase in merger activity in the long run. Until recently, the proposed abolition of "pooling of interest" accounting was thought likely to discourage mergers by requiring their costs to be set against profits. But new proposals, due to be

agreed soon, should be much more deal-friendly than was once feared.

Indeed, despite the recent slowdown, the forces driving global consolidation remain powerful. That is why the likes of Mr Lipton talk in terms of the present merger wave merely pausing, rather than ending. Yet the pause is likely to last until vigour returns to the financial markets and the world's economies, particularly America's. Until then, many company bosses will be putting their plans for world domination on ice.

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Power shoppers

Jan 25th 2001 | FRANKFURT
From The Economist print edition

SCARCELY a day now passes without a story about heady manoeuvrings by boring old European utilities. Not a few such tales involve one or other of Germany's two biggest power producers, RWE and E.ON. Add up all the rumours, as well as the statements from the companies themselves, and it seems that they are interested in spreading their wires across almost every country in Europe—and beyond.

No wonder people get confused. Last week Otto Majewski, deputy chairman of E.ON's energy subsidiary, told the press that the firm was not in talks with PowerGen, a British electricity company. Ahem, said E.ON, in fact we are. Under pressure after this breach of American disclosure rules (E.ON's shares trade in New York), Mr Majewski resigned on January 24th.

Besides PowerGen, E.ON says it will buy the whole of Sweden's Sydkraft, a power company of which it already owns more than 40%. RWE has confirmed it is looking at Hidrocantabrico, a Spanish utility. Both German firms are keen on Central Europe, and their interest in Spain extends beyond RWE's interest in Hidrocantabrico. They hope to pick up some of the assets that Endesa and Iberdrola, suppliers of 80% of Spain's electricity, might be forced to sell if their planned merger goes ahead.

Why are the Germans such keen shoppers? In part, it is because the liberalisation and restructuring of Europe's energy markets are creating opportunities that did not exist before (see table). But they are also looking abroad because the prospects of expansion at home look so limited. The domestic power market, which was deregulated in 1998, seems to be settling down to being dominated by four firms—RWE, E.ON and two smaller utilities, HEW and Energie Baden-Württemberg.

New generation

Biggest utility mergers and acquisitions in Europe
1998-2001

Acquirer	Target	Value of deal, $bn	Date completed
Veba (Germany)	Viag (Germany)	13.15	June 16th, 2000
Endesa (Spain)	Iberdrola (Spain)	12.96	Pending
Texas Utilities (US)	Energy Group (Britain)	10.95	August 19th, 1998
RWE (Germany)	Thames Water (Britain)	6.26	December 29th, 2000
Scottish Hydro-Electric (Britain)	Southern Electric (Britain)	4.47	January 7th, 1999
RWE (Germany)	VEW (Germany)	3.41	November 24th, 2000
WPD Holdings (Britain)	Hyder (Britain)	3.40	October 26th, 2000
Electricité de France (France)	London Electricity (Britain)	3.20	December 4th, 1998

Source: Thomson Financial Securities Data

RWE and E.ON are themselves the product of changes in the German market, having undergone big mergers last year. RWE took over VEW, another German electricity company, while E.ON was formed out of the fusion of Veba and Viag. Both RWE and E.ON are now trying to turn themselves from sprawling conglomerates into international "multi-utilities"—suppliers not only of electricity but also of water and gas.

This metamorphosis involves stripping out peripheral businesses and expanding the utility-based "core". The two companies have sold, or are planning to sell, their interests in telecoms companies. E.ON has

also got rid of packaging and electronics subsidiaries. RWE took a bold step into broader utility markets last December when it bought Thames Water, a British water-and-sewerage company, for £4.3 billion ($6.3 billion).

However, both companies still have some way to go. RWE has majority stakes in Heidelberger Druckmaschinen, which makes printing machinery, and Hochtief, a construction company. Admittedly, RWE now keeps its non-utility activities at arm's length; it may possibly be waiting until next year, when it will be able to sell its stakes free of capital-gains tax. E.ON's "core" still includes chemicals. Ulrich Hartmann, E.ON's boss, has suggested privately that this business might eventually go.

A bigger black mark against E.ON is that it is building up a cash pile—so far, its sales have raised *euro*17 billion ($16 billion)—without seeming to know what to do with it. Talks last year with Suez Lyonnaise des Eaux and SAUR, two French water companies, and with America's Azurix came to nothing. Some analysts would be more impressed by a water or gas deal than by a takeover of PowerGen, which would cost perhaps *euro*8 billion. Some also point out that delay could be as bad as a hasty purchase. If it waits too long, they suggest, E.ON may succeed only in transforming itself from predator to prey.

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Service with a smile in Siberia

Jan 25th 2001 | KEMEROVO
From The Economist print edition

SUCCESSFUL Russian businessmen usually see a luxury car (armoured, and with tinted windows) as a central feature of their personal remuneration package. But Igor Lysenko, a thrifty 29-year-old marketing graduate who owns a chain of car-parts and service outlets in Kemerovo, a large mining town in southern Siberia, drives a modest Ford. He explains crisply: “There is a Ford dealership here so I can have it serviced easily. The nearest Mercedes place is hundreds of kilometres away, on very bad roads.” By the time your limo’s back from one service, he jokes, it will need another.

Mr Lysenko’s thriving small business, called Koleso (or “Wheel”), would be unremarkable in such post-communist countries as Estonia or Hungary. But in Russia it is still an exception—and not just because of the modesty of its proprietor. Most Russians buy their car parts from tiny shops that offer a limited and unpredictable range of often counterfeit goods. The only alternative is in a few big cities, where dealers with western franchises charge thousands of dollars for simple parts and service.

Wheel, by contrast, worries about standards, branding and marketing. “The client should get the service in the place he wants and at the time he wants, for the price he can pay,” says Mr Lysenko earnestly. His uniformed, well-paid workers (average age 28) are carefully selected not just for their mechanical skills, but also for other much rarer abilities in Russia, such as teamwork and exactness. Many are former military types who “understand about taking orders and being punctual”. The company recently came fourth in an all-Russian marketing competition.

Last year’s tax reform has helped Wheel a lot. It took on an extra 130 workers during the year, increasing its workforce by around a fifth. Not that the local authorities are grateful. In fact, officials are one of Mr Lysenko’s biggest headaches. None of his service centres has a mains water supply—the local hydrocrats demand an upfront payment of as much as $15,000 before even considering a new connection. The fire brigade and other city services are no better, he complains, just “municipal rackets”. Security is less of a problem: “Our workers tend to be fairly hefty types, and we have a panic button to call the police in every service station.”

Mr Lysenko is pessimistic about changing officials’ habits. Politicians are too weak to tackle corruption, he says. What about lobbying through the local Rotary Club? “I’m not a member. That’s for people who drive Mercedes,” he sniffs.

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Face value

Joining the club

Jan 25th 2001
From The Economist print edition

Clara Furse will make a tough, determined boss for the troubled London Stock Exchange. But does she know where to lead it—and does she have the diplomatic skills to take its shareholders with her?

PRETTY in pink, petite and partial to pearls: it would be easy to misjudge Clara Furse. The new chief executive of the London Stock Exchange (LSE) has built her career in the world of derivatives-broking on a reputation for ruthlessness. There has been a predictable fuss about the appointment of a female foreigner—Mrs Furse is a Dutch polyglot and not-too-distant relative of the Siemens family—to lead a stock exchange that still seems like a very British gentlemen's club. And it comes as part of a broader shake-up: no fewer than five non-executive directors are to be replaced. Nor is her new job known for its security. The previous three incumbents left prematurely, spat out by the exchange's disgruntled shareholders.

But Mrs Furse has come up through a harsh school. To reach the top of the derivatives business requires a thick skin (and a tolerance for blue jokes). In her last job, as chief executive of Crédit Lyonnais Rouse, the derivatives arm of the French bank, she cut staff numbers by three-fifths, before quitting in December, in search of a "new challenge". Earlier, as a deputy chairman of the London International Financial Futures & Options Exchange (Liffe) between 1997 and 1999, she presided over the ousting of its chief executive, Daniel Hodson, after Liffe lost most of the market in an important contract to its German rival.

When Mrs Furse starts work next month, the mood at the LSE tower in Throgmorton Street may seem unnervingly familiar. Like Liffe, the stock exchange is facing fundamental questions about its future. It has lost its once-total dominance of Europe's international share-trading. Frankfurt's Deutsche Börse, formerly just one among several German regional exchanges, has, under the charismatic (if abrasive) leadership of Werner Seifert, become a serious rival. The LSE also resembles the old Liffe in that it is still riven by the competing interests of its owners. Last March it dropped its mutual ownership structure, but, on the whole, its shareholders are still its customers. None is allowed to have more than 5% of the voting rights, so any change is easily vetoed. Finding a strategy acceptable to this wide spectrum of shareholders—ranging from regional stockbrokers to huge American securities houses—will be the priority for Mrs Furse and her chairman, Don Cruickshank.

It will not be easy, as was shown by the LSE's abortive efforts last year to carve out a new future for itself. Its strategy of pursuing European consolidation has failed. A putative eight-way alliance with other European exchanges, unveiled in 1998, fizzled out. And Gavin Casey, Mrs Furse's predecessor, resigned last September after LSE shareholders' objections had forced it to ditch a proposed merger with Deutsche Börse, to form "iX". The LSE also had to see off a cheeky takeover bid from Sweden's OM Group, which runs the much smaller Stockholm stock exchange.

The big banks, led by the American triumvirate of Morgan Stanley Dean Witter, Goldman Sachs and Merrill Lynch, pushed the iX deal, hoping to reduce trading costs. But, worried that trade in domestic stocks would take second place to pan-European equities, smaller brokers revolted. In the long run, the LSE may have to look at European alliances or mergers again, though Mrs Furse insists that the exchange does not "need to do a corporate deal". In the short term, a deal with either Deutsche Börse or Euronext, the merged French, Dutch and Belgian exchanges, is,

at any rate, off the agenda: both are busy with plans for their own stockmarket flotations.

However, they, like America's Nasdaq, remain keen to link up with London, still Europe's most attractive share-trading location. The alternative for the LSE is to go it alone, and concentrate on building its own brand. This, by default, is the present strategy. Next month, the LSE plans to launch, with the London Clearing House (LCH) and Crest, Britain's settlement service, a central counterparty through which share-trading would be conducted. This should cut costs by reducing the number of trades to be settled and the amount of capital banks have to set aside when trading.

A marriage for Liffe?

Another option, favoured by smaller brokers, is for various London institutions to merge. The most obvious link-up would be between the LSE and Liffe, but that seems unlikely, despite Mrs Furse's warm relationship with Liffe's bosses. Even more improbable is the four-way merger of share- and derivative-trading, clearing and settlement that some in London argue is needed to counter the financial muscle of, for example, Deutsche Börse, whose market value is almost three times the LSE's. Neither Crest nor the LCH is keen to give up its independence. Moreover, the big banks and securities houses prefer what has become known as an "hourglass" solution, where a number of exchanges compete with each other but use a common, pan-European central counterparty, and a few settlement houses.

The LSE's strategy, in a word, is a mess. In her effort to sort it out, Mrs Furse has one good qualification (besides being a mother of three): she is, whines one senior manager who crossed her, "a bully". The ability to get things done has been sorely missing in Throgmorton Street, but it is not enough. The LSE's ownership structure demands tact as well as strength of personality. In particular, Mrs Furse will have to work with, in Mr Cruickshank, an activist chairman used to calling the shots. Even if he lets her run the show, there is a bigger question-mark over Mrs Furse's talents. Though an unstoppable executive, she is not known for being a visionary. And what the LSE needs even more than a dynamic leader is one who can see where it is going.

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European airlines

Sorry to announce...

Jan 25th 2001
From The Economist print edition

THE restructuring of Europe's fragmented airline industry is proving to be as troublesome as Sabena's first long-haul flight in 1925, when one of its Handley Pages took off from Brussels for Africa, to arrive at its destination only 51 days later. After losing lots of money ever since, the future of the Belgian airline now depends on being part of SAirGroup, the parent of Swissair. SAirGroup has bought stakes in a number of ailing airlines, including Sabena, in an attempt to create an alliance of carriers to compete against bigger rivals. But on January 23rd, that flight plan ended in tatters when the group dumped its chief executive, Philippe Bruggisser, and slammed his strategy into reverse thrust.

Mr Bruggisser's survival plan had begun to make his board of directors nervous. The alliance that he was building, called Qualiflyer, was quickly draining the group's resources. Some analysts thought that SAirGroup would do better by concentrating on its successful diversification into airline services, such as flight catering, airport retailing and cargo handling, where it is among the world leaders.

There was also concern that Swissair's reputation for comfort and reliability would be sullied by its less glamorous partners: besides Sabena, SAirGroup holds stakes in Austrian Airlines, Poland's LOT, South African Airways and three regional French carriers. The list was growing: Mr Bruggisser had agreed to buy 34% of TAP Air Portugal and was discussing deals with Turkish Airlines, Malaysian Airlines and Alitalia. It was Sabena's financial woes, however, that seem to have been the final straw. In 1998, the Belgian airline had reported its first profit of any significance in 40 years, but then immediately dived back into loss. It is thought to have lost *euro*200m ($184m) last year.

On January 20th, the Belgian government, which is Sabena's majority shareholder, said it would invest an extra *euro*100m in the carrier. SAirGroup, which has an option to raise its stake from 49.5% to 85%, would put up an additional *euro*150m. This money will go towards a *euro*750m restructuring plan, which Sabena's unions have yet to support. The European Commission also has to approve the deal.

None of this impressed SAirGroup's board. After Mr Bruggisser resigned, the company said its alliance strategy would now focus on making the airline business profitable. Eric Honegger, the group's chairman, warned that it might withdraw from the Sabena rescue if the unions did not accept the restructuring unconditionally. He also said the group would not take any more stakes in other airlines.

This suggests that instead of trying to build up Qualiflyer, SAirGroup may decide to throw in its lot with a bigger, global alliance. A prime candidate could be OneWorld, led by British Airways (BA) and American Airlines. Swissair already co-operates with American on transatlantic routes.

The Swiss group's troubles show how difficult it is for Europe's airlines to adjust to an increasingly deregulated environment through the sort of mergers that have reshaped the American airline industry. Continued meddling by governments, entrenched positions at congested airports and restrictions on foreign-ownership rules frequently stymie deals. An ambitious attempt by BA and KLM of the Netherlands to break out of their national straitjackets and form a giant international carrier broke down in September over KLM's reluctance to cede too much control. On January 19th, Spain's national airline, Iberia, ended talks to buy Air Europa, a struggling rival, because of disagreement over the price and over where job cuts would fall.

The established European airlines are also finding it difficult to compete with new low-cost carriers, such as Ireland's RyanAir and Britain's EasyJet. Some, such as BA—and quite possibly now, Swissair—are trying to consolidate around the more profitable parts of their operations, such as business travellers. BA has even put its low-cost subsidiary, Go, up for sale. So far, there have been no takers.

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Computing

The penguin gets serious

Jan 25th 2001
From The Economist print edition

Get article background

LINUX, the free computer operating system developed by thousands of volunteers collaborating over the Internet, is still not taken very seriously in corporate circles. It is used for niche tasks, such as running web servers, but it is generally deemed to be too immature for the most demanding environments, such as heavy-duty database systems. Recent events, however, suggest that Linux—whose mascot is a cheerful penguin—may have outgrown the commune of its birth.

On January 4th, Linus Torvalds, the Finnish programmer who co-ordinates the development of Linux (see article), quietly released the latest version of the Linux kernel—the software that, as its name suggests, is at the core of the operating system. Many of the enhancements in this new kernel (version 2.4) make Linux more suitable for corporate use. In particular, they make it more "scalable"—in other words, as capable of working on very large computer systems as on small ones. Linux 2.4 can support more processors, more memory, and faster networking and disk access—all prerequisites for industrial-strength corporate use.

Just as the software itself has become more solid, so support for Linux within the computer industry has also been growing. IBM, which has embraced Linux across its product range, from PCs to mainframes, announced in December that it would spend $1 billion on Linux-related activities in 2001. And this week the Open Source Development Laboratory, an independent, not-for-profit research centre financed by such industry giants as IBM, Intel and Dell, opened its doors. It is intended to accelerate the adoption of Linux in business computing, and to allow developers to test their software on the largest systems. In other words, with the notable exceptions of Microsoft and Sun Microsystems, the industry is pushing Linux for use in corporate computing.

Linux is also proving a popular choice for powering Internet appliances, such as handheld computers and smart telephones. And, at the other end of the scale, it is emerging as a powerful force in the specialist field of supercomputing. By connecting hundreds of PCs running Linux in a "cluster", it is possible to construct an enormously powerful machine for a fraction of the cost of a conventional supercomputer. IBM recently started installing a 1,024-processor Linux supercomputer at Shell's research centre in the Netherlands, where the oil company plans to use it to analyse geophysical data and to help it find oil. And on January 16th, America's National Centre for Supercomputing Applications said that it had agreed to buy two Linux supercomputers from IBM, one of which will be the fourth-fastest supercomputer in the world when it is switched on this summer.

There are some fears that the embrace of Linux by big computing companies could prove a mixed blessing. George Weiss of Gartner, a research firm, suggests that IBM, in particular, "looms like a shadow" over the future of Linux; its obvious enthusiasm, he says, might deter new firms from entering the market for Linux support and services. Any attempt by big computing companies to hijack Linux, declares Eric Raymond, an open-source guru, would be counter-productive, since it would alienate the very people from whom Linux draws its strength. Yet it is inevitable, as Linux becomes increasingly popular, that it will shed the revolutionary cachet which, for some of its supporters, is its greatest appeal.

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Health care in America

Reconstructive surgery

Jan 25th 2001
From The Economist print edition

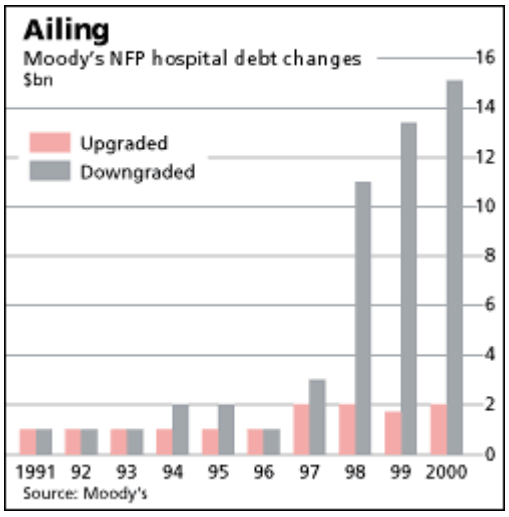
Caught in the cross-currents of conflicting goals, erratic government policy and costly changes in technology, America's philanthropically organised community hospitals are going the way of the family farm

AP

TO GET a sense of how the business of delivering medicine in America fluctuates between utter disaster and extraordinary business opportunity, consider the case of Sharon Hospital in Connecticut, one of America's 4,300 non-profit hospitals. Along with superb demographics—it is in one of the richest counties in one of America's richest states—Sharon benefits from being almost an hour away from competing institutions. Go into labour or crash your car in north-western Connecticut, and it is the obvious choice for care.

Providing a necessary service with little competition should surely guarantee success. But recent results argue otherwise. The hospital has lost $10m in the past three fiscal years. Revenues are stagnant, costs are growing and mounting losses make it increasingly hard to finance expensive new equipment. Sharon, in short, is on life support. Nor is it alone: change a few details and the story is being repeated throughout America.

Over the past decade, 10% of America's community hospitals have closed, even as an ageing population is demanding ever more health care. Many of the surviving hospitals are in poor shape. Their operating margins are less than 3% on average, a level that cannot hope to cover capital costs; and their debt is being downgraded as never before (see chart). Given the fragile state of the business, the only surprise is that more hospitals do not close. Of Connecticut's 31 full-service hospitals, Sharon officials say a third are losing money and several could fail.



The main problem facing hospitals is a business environment that has been made unforgiving as both government and business seek to control health-care costs. The easiest place to begin was with revenues. In 1997, Congress was justifiably terrified by the prospect of an insolvent Medicare—the main health-insurance scheme for the elderly and the source of half of all hospital income—so it cut the programme's reimbursements to hospitals. Less justifiably, it allowed the Medicare rulebook to swell to 45,000 pages.

If the government was tough, the private sector has become even tougher. Businesses of all sorts have shifted medical coverage to health-management organisations that, according to their critics in the industry, reimburse hospitals based on three strategies: low pay, slow pay and no pay. Merely qualifying for reimbursement requires mastery of a staggering number of contractual arrangements. Hospitals in densely populated areas may accept as many as 200 different company health-care plans.

If that were not enough, the value provided by hospitals has also shifted. Beds are out; high-tech equipment for imaging, non-invasive surgery, digital mammograms and the like is in. This transformation requires money and vision. Like many other hospitals, Sharon lacked at least one of these attributes, if

not both.

Last June it took a radical step, agreeing to be bought by Essent Healthcare, a new, for-profit institution. Although for-profit hospitals are common in the south and west, they still amount to less than 15% of the industry, by number of hospitals, and are particularly sparse on the east coast. New York has gone so far as to outlaw ownership of hospitals by publicly traded companies.

One concern over deals such as Sharon's is that if a municipal institution cannot now break even, how can it produce enough profit in future to satisfy an investor? There are also fears that profits may detract from care. The state of Connecticut, which must review the deal, has asked for information on the hospital's property holdings, presumably to understand whether the transaction is a thinly veiled liquidation.

As is also typical in privatisations, the sale of Sharon is awkward. Any approval by regulators is months away. The purchase price, $16m, has strings attached. In a move that would be unacceptable in the sale of most companies, the consultancy handling the deal, Cambio Health Solutions of Tennessee, is also providing a temporary chief executive. Her approach to routine business matters such as bill collection will have a big impact on the final price.

Given these impediments, it would not be a surprise if Sharon were merely allowed to close. That the deal remains alive in spite of such problems reflects another odd fact: most hospitals may be struggling, but they can in principle be turned into extraordinarily profitable businesses.

The evidence comes in the results of shareholder-owned hospital operators. During 2000, a horrendous year on Wall Street, shares of these outfits more than doubled. Their operating margins range from 13% to 24%. Essent's main financial backer is Thoma Cressey, a Chicago buy-out firm that boasts annualised returns of 30%. Its partners have done particularly well out of early investments in two publicly traded hospital companies, Province Healthcare and Health Management Associates.

The factors behind the success of for-profit hospitals are controversial. They may scrap research—not a big department at Sharon, but costly at larger hospitals. They may also take a harsh line against providing charitable care for the poor, although Essent has promised not to do so. HCA Healthcare, the largest for-profit chain, has admitted charges of Medicare-related fraud, among other problems, and paid almost $1 billion in penalties in a series of cases stretching out over the past five years.

The best argument for the profit motive, however, is that increasingly complicated institutions demand increasingly sophisticated management. Inventory control, price negotiations with suppliers, processing patients and financing new equipment are all tricky tasks. Pushing Sharon's costs down to the standards of for-profit hospitals would, Essent estimates, save $5m a year, eliminating its operating loss. Luring local residents who go elsewhere for non-urgent care could add another $3m to the bottom line. As hospitals have substantial fixed costs, incremental business can bring large returns.

More than two dozen American hospitals were privatised last year. That number is expected to rise. In December, a municipally owned institution in Haverhill, Massachusetts announced that it faced potential ruin, echoing earlier cries in, among other states, Ohio, Missouri and Alabama. The federal government may be pumping in a bit more money, but the next crisis is never far away. A decade from now, it would not be surprising if all non-profit hospitals, except those with generous patrons or unusually competent management, were closed or sold.

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Video games

Cast aside

Jan 25th 2001 | NEW YORK
From The Economist print edition

VIDEO games may be violent and brutal, but they are nothing compared with the business of making them. Look no further than Sega, the Japanese firm that, despite a passionate following, has been on the losing side of the game wars for most of its existence. Its Dreamcast console is the best, most powerful machine you can actually buy today (since Sony's Playstation 2, or PS2, is in such short supply), and Sega has shifted over 6m Dreamcasts since its release in late 1999. Yet on January 24th, Sega sounded its surrender. It plans to stop production of Dreamcast hardware and focus on making software for its own machines and those of rivals, including the PS2, Nintendo machines, Microsoft's forthcoming XBox and the PC.

Rather than punishing the firm for its failure, the stockmarket sent Sega's shares up by 15.7% on the day of the news. This was not as irrational as it might seem: Sega, like most other game makers, sells its hardware at a loss, hoping to compensate with royalties on software sales. This is by itself nothing new: think razors and blades. The difference is that game consoles cost several hundred dollars to make. In the early days of their life, before manufacturing efficiencies kick in, losses can exceed $100 per unit. Overall, Sega has lost more than $500m over the past two years by subsidising Dreamcast sales, without winning the market share to make it up in software royalties.

As a result of such savage economics, the business is increasingly becoming a winner-take-all game. Because the cost of making games is rising, increasing the cost of betting on the wrong platform, the best software developers soon shun the laggards. And consumers, of course, buy the machines with the best games. This leads to a virtuous circle for the winners—at its peak in 1999 the market-leading original Playstation accounted for more than 40% of Sony's profits—and a death spiral for the also-rans. The potential profits of only making software are lower, but so is the cost of failure.

This is a sobering lesson for others, too. Sony is in the money-losing early days of its PS2—it has just halved its profit forecast for the year. If that machine eventually dominates the market, just as the first Playstation did, its current woes will be forgotten in the flood of profits that follow. But Sony's failure to make enough of the PS2 in the crucial early months puts that future in question. Consumers now realise that they may have to wait until the autumn to get their hands on a PS2. By that time the hype will have shifted to the XBox, which Microsoft claims will be more powerful, or even to Nintendo's next console, the GameCube, scheduled for release late this year.

No wonder Sony's shares fell on news that its main competitor was heading for the exit: it was further evidence of just how tough the console market is. So spare a thought for Microsoft, which despite its might in software has made neither a games console nor anything else of note in consumer electronics before. Likewise, despite the success of its handheld Gameboy, Nintendo is preparing for its next generation from a weak position, with sales of the ageing N64 slumping. The spectre of Atari—which almost sank Warner Brothers, its parent, when it imploded two decades ago—still haunts the industry. Now it is to be joined by Sega's hardware arm. How long before another once-proud console maker follows?

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Fiddling while Marunouchi burns

Jan 25th 2001 | TOKYO
From The Economist print edition

Japan's problem banks present one of the greatest financial threats to the world economy. Half-hearted efforts to restore them to health have failed. It is time for more drastic measures

THE bankers in Marunouchi, Tokyo's financial district, know that one more big client's bankruptcy or a further slide in share prices could push them into an abyss that they prefer not to contemplate. The possibility of either event is far from remote. Among the candidates for collapse are big construction companies such as Kumagai Gumi and retailers such as Daiei, a supermarket chain. Meanwhile, the stockmarket, close to its lowest level for a decade, is levitating only after a promise earlier this month from the ruling Liberal Democratic Party (LDP) that it will come up with proposals to prop up share prices. If those proposals fail to materialise, or to meet expectations, the cushion of unrealised equity gains on the banks' balance sheets could soon deflate.

It should not be like this. Japanese banks have been on the brink of disaster before. After the most recent crisis (in 1997-98) the government set up a special body, the Financial Reconstruction Commission (FRC), to clean up the country's financial system. The FRC was due to complete its task by 2001. But almost the only thing that went according to plan was the closure of the FRC itself at the beginning of this year. The banks are still far from meeting the goals set out for them by the government in 1998; they remain burdened with bad debts, poor profitability and a lacklustre economy. Indeed, they may be in a worse state now than they were then.

At the root of the problem lie poor lending decisions. Since the early 1990s, the banks have written down almost twice their entire capital and reserves in an attempt to get rid of their bad loans. But those bad loans have stubbornly refused to go away. Official figures show that non-performing loans are barely falling at the big banks, while at the regional banks they are actually increasing.

Part of the trouble is that the banks are incorrectly classifying their loans. Last March, for example, Sumitomo had analysts scratching their heads when it reported that it had only ¥265 billion ($2.26 billion) of problem loans to the construction industry, a figure smaller than the bank's total exposure to Kumagai Gumi, just one big troubled company. A few months later, Kumagai Gumi asked Sumitomo and three other banks to restructure its debts, and Sumitomo is now due to write off ¥260 billion in an effort to save Kumagai from bankruptcy.

The extent of such erroneous classification is further illustrated by the loan books of The Long-Term Credit Bank (LTCB) and Nippon Credit Bank (NCB), two nationalised banks. They were meant to have been stripped of their deadbeat loans by the FRC, and then sold to third parties. But even after the official "clean-up", loans to companies such as Sogo, a department store that later went bust, were left sitting on the books as "good" assets.

In addition, there is a widespread fear that the banks have overestimated the value of the property backing many of their loans. Urban land prices, for example, have fallen by up to 80% since their peak in the early 1990s. This means that the banks have undervalued the portion of those loans without collateral—ie, the portion against which they need to hold reserves. For such reasons, the estimate of the Financial Services Agency (the FSA, the industry watchdog) that the banking system had problem loans of ¥63.3 trillion last March, is generally thought to be as much as 50% below the true figure.

Little help from profits...

One reason why the banks are unable to lift themselves out of trouble is that they are finding it hard to make decent profits. Brian Waterhouse of HSBC Securities reckons that even though they are, after several years of heavy losses, forecasting profits for the year ending in March 2001, much of this recovery is down to the fact that they are cutting costs by reducing their bad-debt provisions and write-

offs.

Profits from equity sales have also helped to boost profits in the first half of the year. James Fiorillo, an analyst at ING Barings, believes that the banks may even have reduced much-needed investment in IT so as to bolster their profits, endangering their long-term competitiveness. The banks are having to resort to such last-ditch measures largely because they are still losing money on their core lending business, and they have been unable to develop fresh fee-based business as an alternative source of revenue.

Some are hoping that four mega-mergers orchestrated among a number of the ailing banks—mergers that will create some of the biggest financial institutions in the world (see table)—will help get them out of trouble. But the chances of this working are slim. Instead of seeking to improve the banks' profitability through strategic alliances, the mega-mergers have merely sought to make them "too big to fail".

Yanagisawa's big problems get bigger

Japan's megabanks

New bank	Banks included	Date of merger/ set-up of joint holding company
Mitsubishi Tokyo Financial Group	Bank of Tokyo-Mitsubishi, Mitsubishi Trust and Banking, Nippon Trust Bank	Apr 2001
Mizuho Financial Group	Dai-Ichi Kangyo Bank, Fuji Bank, Industrial Bank of Japan	Sep 2000
Sumitomo Mitsui Banking Corporation	Sakura Bank, Sumitomo Bank	Apr 2001
United Financial of Japan Holdings	Sanwa Bank, Tokai Bank, Toyo Trust and Banking	Apr 2001

Source: Company reports

Not surprisingly, more than a year after their announcement, the mergers are still largely in the planning and preparatory stage. The banks have, for example, yet to integrate their systems fully. This is much too slow, says an irritated Hakuo Yanagisawa, minister in charge of financial affairs, who was also in charge during the early stages of the banking reforms two years ago.

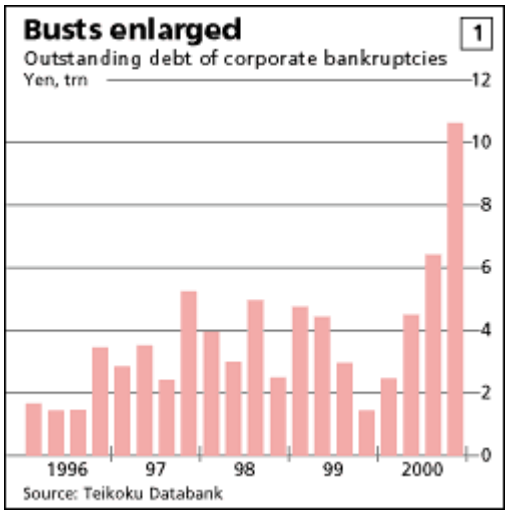
The pace is unlikely to pick up. Mr Waterhouse says it will be particularly slow at Mizuho (which brings together Dai-Ichi Kangyo, Fuji and Industrial Bank of Japan) and at United Financial of Japan (a combination of Sanwa, Tokai and Toyo Trust). These two groups have chosen to assemble themselves under joint holding companies, a structure that takes more time to set up than an outright merger. Meanwhile, the plodding godzillas are in danger of having their market share stolen from them by nimble new competitors, such as the new banks being set up by the likes of Sony, Ito-Yokado, a retailer, and Orix, a leasing company.

...or from the economy

None of this would be quite so alarming if the Japanese economy were on the road to full recovery. Unfortunately, it is not. Japan's heavily indebted companies are still struggling to sell things to reluctant consumers while buckling under rising burdens of debt. This is because the economy, although growing in real terms, is not growing in nominal terms—ie, growth is low and inflation is negative. Since debts are

always nominal (in the sense that borrowers must pay back the nominal amount that they borrowed), the ability of firms to service their loans rises only with nominal increases in profit, not with deflation-adjusted increases. Hence, cleaning up after Japan's asset-price bubble is getting harder. Bankruptcies are continuing at a high level (see chart 1), and requests for debt waivers still flood in.

Some bits of the economy are recovering, but this is not helping the banks much. Most of the restructuring that is the basis for recovery is in industries and companies which are able to withstand some short-term pain. So good companies are getting stronger while the bad ones remain weak. The best borrowers are also shifting their fund-raising to Japan's fledgling capital markets, with the result that the banks' customers are becoming increasingly concentrated on the rotten sectors.



To some extent, the banks have been able to disguise their ills because of the unrealised equity gains that they have on their balance sheets. But plunging stockmarkets are wiping out most of these. This matters more and more because Japan is due to introduce market-value-based accounting this year—meaning that unrealised securities losses will start being deducted from their capital. With such losses to account for, the banks will be less willing than ever to undertake write-offs of their bad debts.

Hironari Nozaki, an analyst with ABN Amro, reckons that if these equity losses keep growing, they might even push down retained profits to the point where some banks are unable to pay dividends. At this point, they would also have to stop paying interest on their preferred subordinated debt, since this cannot be paid before dividends. If this were to happen, warns Mr Nozaki, the so-called "Japan premium", the extra interest that international institutions began charging Japanese banks during the 1997-98 crisis, could start moving up.

With so much riding on the stockmarkets, it is little wonder that they are the subject of the politicians' attention. According to Mr Fiorillo, ten out of the 14 biggest banks have ¥2.1 trillion of unrealised losses on their equity portfolios at current stockmarket levels (with the Topix index at about 1,250). Given that the banks themselves are eager to sell their large shareholdings in firms within their own *keiretsu* (or group), further falls seem likely. Although it is hard to say exactly where the real danger zone lies, it is clear that share prices are slipping close to it.

The authorities claim that the banks are healthier now than they were two years ago because their capital position is so much stronger. They point to the banks' Basle ratios, which averaged around 12% last September. (For banks with overseas operations, the Basle minimum is 8%.) But beware, says Mr Fiorillo, for these are not what they seem. They are flattered by unrealised gains on property valuation; by deferred tax assets that might disappear if the banks don't make lots of profit over the next five years; and by public funds that the banks will also have to pay back out of profits. Strip these out and the ratios are pushed down to around 6.2%; take into account unrealised equity losses and you can knock off another point or two. Either way, the number falls well below 8%.

The Japan premium, however, is today practically zero, signalling that international financiers believe that Japan's banking system will not seize up again. It has placed its faith in the colossal safety-net that the government strung under the banks at the height of the 1997-98 crisis. Moody's, a credit-rating agency, argues that although the banks individually stink (it rates many of them as "E" or "E+", on a par with the average bank in Mexico or Russia), the promise of public support greatly raises their collective stability, giving them an average credit rating of "A". This shows how crucial the government's safety-net is. Yet from April it is to have some sizeable holes in it.

The ¥70 trillion cushion, created in 1998, is a complicated combination of four different "funds" that can be poured into the system in times of stress. A couple of them will safeguard depositors if banks collapse, and a couple are for the banks themselves. One is for banks which go bust—to nationalise them, for example—and about a third of the ¥18 trillion in this fund has already been spent. The ¥25 trillion in the other bank-related fund is to recapitalise unhealthy banks; and ¥8.4 trillion of this has already been used.

It might seem as if a hefty sum is still available. And so it is. But not for much longer; the two bank-related bits of the safety-net are to disappear at the end of March. Some ¥26 trillion will be set aside for

the credit unions, but none of this will be available for banks. Instead, a ¥15 trillion “systemic risk” fund will be set up for emergencies. The prime minister, the finance minister, the minister in charge of financial affairs and the head of the Bank of Japan will get together to discuss its use. But the final say will rest with the prime minister alone.

Critics argue that, at best, the way this new fund will work is ambiguous, and that it signals a disturbing move away from transparent bail-outs. More worrying for bankers is the risk that it might not work at all. With no designated framework to release the funds, the process of decision-making will be subjective and will be bound to come under intense public scrutiny, given the level of public anger at the last round of injections into the banking system.

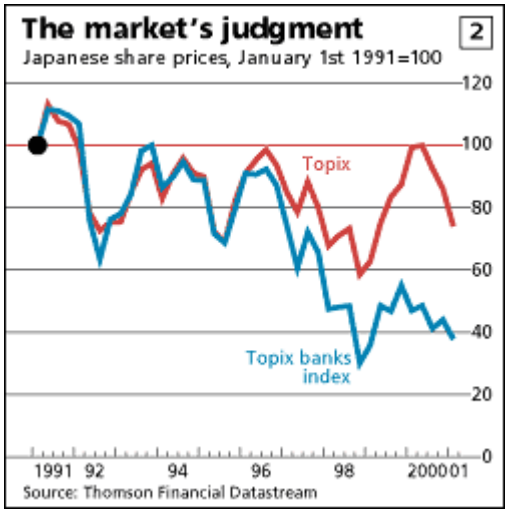
A successful application for funds will require a persuasive and credible politician at the helm. The present prime minister, Yoshiro Mori, is neither. At worst, an attempt to use the systemic risk fund could turn into another fiasco like last summer’s, when the government tried unsuccessfully to use public funds to save the Sogo department stores.

Where next?

With the clock ticking and the environment deteriorating, the question of what to do about Japan’s ailing banks is gathering new urgency. What is becoming clear is that it is not enough to consider the banks in isolation. For every problem loan there is a troubled borrower. And the clean-up of these borrowers has hardly begun.

At the moment, the banks and the rest of the economy are caught in a vicious cycle. Banks have been all too willing to forgive debt or to provide new credit lines in order to keep deadbeats on their feet, and this has hindered the structural reforms needed to revive the economy. This, in turn, is sapping the banks’ own strength, leaving them reluctant to take on more risk by lending to the young businesses that should be leading Japan out of recession. Despite promises to the contrary, domestic bank lending has fallen to its lowest level in nine years.

The banks’ policies are also increasing deflationary pressures. Large corporate white elephants are slashing prices to maintain day-to-day cashflow, safe in the knowledge that even if this leads to more losses, the banks will eventually come to their rescue. This, in turn, is weakening their healthier competitors, whose profit margins are being squeezed as they try to match the price cuts and remain competitive.



This cycle must be broken. But the banks lack the will to do it. One of the biggest mistakes that the government made during the previous injection of public funds into the industry was to leave in office all of the bank bosses who had caused the problems in the first place. The survival of these elders, who are naturally loth to admit that their houses need cleaning, contrasts sharply with the experience in America and South Korea. There, scores of top banking executives were sacked, and some were even thrown into jail.

Japan ought to do several things now. It should enforce stricter reporting and disclosure of bad loans; it needs to inject more money into the banks so that they can write off all their bad debts; and bank managers should be sacked, so that new ones can be put in their place.

Temporarily nationalising the banks, by declaring them insolvent or as having inadequate capital, may be the only way to accomplish all this. Even with strict supervision, the banks will probably find it hard as independent entities to cut off favoured customers, alienate the public, hire better management and admit to true shareholder value.

Reformers such as Yasuhisa Shiozaki, an LDP politician, strongly believe that such measures need to be implemented before the time limit on the rescue funds runs out. Yukio Edano of the Democratic Party of Japan (DPJ) has a more dramatic proposal which involves temporarily nationalising weak banks, splitting them into “good banks” and “bad banks”, and then selling the good bits. The proceeds could be used to help deal with the bad bits left in the government’s hands.

Unfortunately, none of these options is likely to be taken up. Reformers have been sidelined within the LDP. Party elders, fearful of upsetting voters, do not want the problems that lurk in the banks exposed before elections to the upper house in July. Instead, the party's mainstream factions are reverting to the idea, discredited years ago, of supporting the stockmarkets. One of their proposals would allow companies to buy back their own shares until they decide to resell them later on. This is a dangerous idea that makes it easier for companies to use inside information to manipulate their own share prices, especially in Japan, which lacks a powerful securities commission.

What does the man in charge think of all this? Mr Yanagisawa is against stockmarket intervention, arguing that not only do such schemes rarely achieve their purpose, but they could also drive away foreign investors. Mr Yanagisawa is also against giving the banks any more public money or nationalising them. He argues, at least officially, that this is because they are so much stronger now. Cynics suggest that he does not want to nationalise banks because it would be tantamount to admitting that the previous injection of public funds, which he oversaw, was a failure.

Mr Yanagisawa does, however, believe that structural and banking reforms should go hand in hand, and he is moving to set up a committee with the Ministry of Economy, Trade and Industry and the Ministry of Land, Infrastructure and Transport to monitor private-sector debt reduction and engineer bank reform. His measures, though, fall short of the real medicine needed to cure Japan's banking ills. Yet if he were to take a tougher stance, Mr Yanagisawa would be unlikely to find enough political allies to back him, at least not until after the July elections. Meanwhile, Marunouchi could burst into flames any day.

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Deal-making done

Jan 25th 2001 | NEW YORK
From The Economist print edition

The problems at Bank of America lay bare one of banking's dominant myths, that big means better

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IT IS a sorry tale for Bank of America and its serial bank acquirer, Hugh McColl, who announced this week that he will shortly resign as chairman. Twenty years ago, America's banking industry meant thousands of small local banks lending to people and small businesses in their neighbourhoods, plus a few big "money-centre" banks that lent to the country's biggest corporations. This multitude of little local banks struck politicians and regulators as a study in inefficiency. They scrapped the laws that stopped banks doing business across state lines, and in some cases even within different parts of the same state. That helped to trigger a wave of consolidation, still far from over, that has cut the number of banks in America from over 14,000 to under 8,500, and that made Mr McColl's name.

More than anyone, he led the charge towards nationwide banking. In 1983, Mr McColl became chairman of the tiny North Carolina National Bank (NCNB), shortly before interstate banking was allowed. He set off on a series of deals that reached their culmination in April 1998, when what had come to be called NationsBank bought Bank of America. The merged giant assumed the latter's name, although it remained firmly in the charge of the former's executives, led by Mr McColl. It became the first, truly coast-to-coast retail bank in the country's history. Measured by number of branches, it is America's biggest bank (Citigroup is larger by assets, because of its non-bank operations) and is a significant corporate and investment bank to boot.

Mr McColl's announcement that he will retire in April, earlier than expected, follows years of disappointing performance at his bank, with mounting write-offs for dud loans. The combined Bank of America is widely regarded in the industry as a beached whale. Its share price is too weak to allow Mr McColl one final mega-deal: a bid for Merrill Lynch, say. Although at the time he got countless plaudits, and magazine covers, for building America's biggest bank, Mr McColl's achievements now look suspect. The Bank of America that is his legacy is "suffering from a combined bout of flu and cancer," according to Tom Brown, a banking analyst—the flu being a growing portfolio of bad loans, the cancer a fundamentally flawed vision. A long-term shareholder in Mr McColl's ever-expanding bank would have done far better to have invested in a broad index of bank shares, to say nothing of better-performing banks.

Whether his failure is down to personal limitations, or to his strategy of building a big, nationwide bank, is not yet clear. In his defence as a manager, large banks pursuing the same strategy achieved similarly poor results. One was First Union, a stone's throw from Bank of America's headquarters in Charlotte, North Carolina. Its boss, "Fast Eddie" Crutchfield, Mr McColl's long-time rival, took early retirement last year.

For someone with a reputation as a master deal-maker, it is remarkable that those who have profited most from Mr McColl's addiction to shopping have been his competitors—First Union excluded—as well as those who sold their banks to him. Even so, he has been handsomely rewarded. Last year, when Bank of America's share price floundered, the board voted Mr McColl a package worth $80m. Only one of his purchases was an unalloyed triumph. In 1988, he bought the troubled First Republic Bank of Texas, in a deal orchestrated by bank regulators. This was well-timed, for the Texas economy recovered soon afterwards. Yet the real value in the deal lay in the tax breaks Mr McColl won. (In the government, he found a worse deal-maker than himself.) Thanks to them, the bank cost little or nothing.

Mr McColl's trademark deals, though, generally involved him paying too much for too little, and then ruining what he had got by cutting costs aggressively in order to justify the ridiculous purchase price. In

1986 he bought Bankers Trust of South Carolina (BTSC), a small bank with a credit-card portfolio that promptly bled losses; possibly in deference to his superiority as a deal-maker, W.W. “Hootie” Johnson, the former boss of BTSC, remains a fixture of Bank of America’s board. In October 1997 Mr McColl paid $1.2 billion for Montgomery Securities, one of California’s leading investment banks. Most of the best investment bankers walked out after a series of rows with Montgomery’s management, and culture clashes with the commercial bankers at headquarters. They are now ensconced in the thriving firm of Thomas Weisel, run by Montgomery’s eponymous former boss. Though Bank of America spent a further fortune trying to revive the investment bank, Montgomery is no longer the serious force it once was in Silicon Valley.

Even more dispiriting was the purchase of Barnett Banks, a hugely profitable operation in Florida, one of America’s fastest-growing markets. Everything that is wrong with Mr McColl’s management style became clear to analysts in the meeting that followed the deal. Asked how he had come up with his proposals to cut expenses by an astounding 55%, Mr McColl’s defence was that extreme pruning was the only way to justify the price he had paid for the bank. Service fell apart, and customers left in droves. This is a pattern—so much so that one rival, Northern Trust, a high-end Chicago-based bank, is believed by analysts to have a strategy of opening branches near banks that Mr McColl acquires, in reasonable expectation of capturing plenty of wealthy customers.

The purchase of Bank of America was the culmination of all that went before. Mr McColl’s reputation and salary expanded, yet his shareholders suffered, customers defected, and the promised integration of NationsBank’s superior technology (for the old Bank of America, a prime motive for the deal) never happened. Credit standards seem to have lapsed badly. In the past year Bank of America has written off billions of dollars in bad loans to companies, and it is expected to be forced to write off billions more. Wall Street tittle-tattle has it that there may be even bigger problems lurking inside the bank, and that if America’s economy turns nasty, the bank might even be a candidate for a bail-out by the Federal Reserve. Even if Bank of America is “too big to fail”, a bail-out still seems implausible. Yet Bank of America’s attempts to quash rumours are not helped by its reputation for issuing misleading statements about its performance.

The record of most other banks that have pursued Mr McColl’s strategy strongly suggests that beyond a certain size any economies of scale in operations are easily outweighed by diseconomies in management and, especially, by the need to pay over the odds to strike a deal in the first place. Perhaps a more modern manager might usefully be brought to bear upon Bank of America. Mr McColl, a former marine, is a lead-from-the-top boss of the old school, uncomfortable with subordinates who challenge his opinions. Talented outsiders picked up during mergers rarely lasted long. David Coulter, the chief at the old Bank of America, was anointed as Mr McColl’s heir-apparent, but was soon expensively eased out. His actual successor is Ken Lewis, one of Mr McColl’s longtime lieutenants, who may prove unwilling to undo the old general’s work.

That Mr McColl’s retirement seems to have been voluntary, despite his lousy record, hardly suggests that Bank of America’s board wants to shake things up. Banking analysts reckon that the individual parts are worth two or even three times Bank of America’s current stockmarket value. Perhaps the bank can be made to work as a whole. But so far the verdict on Mr McColl’s crusade for bigger banks is that shareholders like theirs small.

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Junk bonds

Suddenly improved

Jan 25th 2001 | NEW YORK
From The Economist print edition

IT HAS been a wild nine months for Steven Tananbaum, newish head of Goldentree Asset Management and, some say, the single most astute investor in the market for junk bonds. Astute, as far as junk bonds are concerned, means being able to grasp the market's manic-depressive qualities.

Over a short period, investment returns can be a deceptive measure of astuteness. Many junk investors in the past decade loaded up on the junkiest, highest-yielding paper and then prayed for a forgiving economy. This approach met with some success: a case in point is the high-yield mutual fund run by Morgan Stanley Dean Witter. Yet such funds do appallingly when things turn bad, as they did in the second half of last year. The manager of Morgan Stanley's fund is now pursuing opportunities elsewhere.

Mr Tananbaum's record points to a different approach. Between 1991 and the spring of last year, he managed the single most successful mutual fund for American junk, producing good results when the economy was strong and—equally important—coming through the periodic panics with little more than bruises. Last March he started his own investment company. Even as the rest of the market tanked, his fund's performance was flat. It made a 17% return in the spectacular rebound that has taken place in the junk-bond market over the past three weeks.

The market's nadir at the end of last year, says Mr Tananbaum, was defined by what it did not do: react to favourable news. For example, a troubled insurer, Conseco, reported much-improved profits in mid-December. Yet the distressed price of its bonds did not budge. At the same time, a communications company, United Pan Europe, managed to raise $1.4 billion in convertible financing that was subordinate to its beleaguered bonds. That provided a genuine cushion. The market could not have cared less.

Typically, America's credit markets trade on a spread above the highest quality issue of all, Treasury bonds. By the end of last year relationships had broken down. There may not have been a single junk-rated bond, says Mr Tananbaum, that could not have been bought for less than its initial offered price. How much less depended upon the increasingly arbitrary standards of a shrinking pool of willing buyers.

On the few bonds for which a market was still being made the spread averaged not less than nine percentage points over Treasury bonds, a gap of a size not seen since the early 1990s. And, indifferent as the market was toward success, it was brutal about failure. The price of bonds issued by companies such as National Steel and Algoma Steel fell by half, after two other steel producers, LTV and Wheeling Pittsburgh, went into bankruptcy. If there was a common strand among the worst-hit companies, it was that they needed, or would soon need, cash: the very thing that financial markets were refusing to supply.

Then, as the year ended, the market began to change. Mr Tananbaum says the first whiff of optimism came with reports that, amongst others, Warren Buffett, the boss of Berkshire Hathaway, was hunting for junk. Then the Federal Reserve cut interest rates on January 3rd. Money started to flow into the market from institutions, as well as from individuals who, after yanking money out of mutual funds at the end of last year, are now stuffing it back in. The market has moved violently. In the space of a couple of weeks, the yield on bonds issued by Global Crossing, a large telecoms company, dropped from 13% to 9%, a 30% increase in the bonds' value. Traders are once again offering firmer prices for junk-bond issues. The environment has changed from panic to mere concern.

The average junk bond now yields 12%. That still represents a wideish spread over Treasury bonds of 6.5 percentage points. But, Mr Tananbaum notes, there is still a strong chance that defaults will continue to rise, just as they did throughout last year. Typically, he says, the junk market peaks or bottoms just as the rate of change in defaults (although not the overall level) is about to moderate. Translation: the junk-bond market may be on the mend, though that cannot be said for the economy.

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The Russian economy

Kremlin crunch

Jan 25th 2001 | MOSCOW
From The Economist print edition

RUSSIA faces a slump and renewed inflation, and the authorities are pursuing a policy of "petty hooliganism" in their treatment of foreign creditors. That is not the view of a jaundiced investor, or a cranky russophobe, but of one of the country's brightest economists, Andrei Illarionov. He also happens to be chief economic adviser to the president, Vladimir Putin.

The figures suggest that Mr Illarionov is largely right in his downbeat analysis. Russia's recent spurt of economic growth seems to be tailing off. Industrial production, which had been rising, fell month-on-month in both November and December. The country is awash with cash, thanks to its $60 billion trade surplus. Now, perhaps predictably, inflation is nudging upwards.

Mr Illarionov has taken a hard look at the "windfall" delivered by exceptionally favourable international conditions for Russia over the past couple of years. In 1998 the rouble sank in value by three-quarters, boosting trade competitiveness. The dollar, on the other hand, has risen against most currencies, which has helped Russia to get more for its exports of raw materials, which are priced in dollars. The prices of oil and gas, Russia's main exports, have been especially high.

All things equal, this windfall should have boosted GDP by over 14% last year alone, Mr Illarionov reckons. The actual growth figure for 2000 was only around 7%. So the net impact of economic policy, at a time when the government claims to have launched serious reforms, has been to produce a drag on the economy worth nearly eight percentage points.

Now about half of the competitive gains from devaluation have worn off, thanks to inflation, says Mr Illarionov. He strongly criticises the government's fiscal policy, both for failing to control spending (non-interest expenditure is up 28%) and for not raising taxes. Only 15% of the "windfall" has been captured by the state. Much more has gone on imports and in capital flight.

Mr Illarionov is also scathing about Russia's footdragging over repaying the Paris Club of government creditors. Paying off the country's debt would not only boost the country's image abroad, he argues, but bring healthy economic benefits too, by soaking up the inflationary cash sloshing around the system. The current policy is "pointless vandalism", like smashing up a telephone box.

Mr Illarionov's pessimism is a healthy corrective to the tone of the government and of investment bankers who hope that Mr Putin's heavy-handed regime might at least mean more profits for them. Yet it puzzles those trying to fathom what the Russian authorities are up to. Although Mr Illarionov insists he is not criticising the prime minister, or even the government, his caustic remarks have undermined both the Russian negotiating position with the Paris Club, and the official line that things are improving.

One simple explanation is that Mr Illarionov is an honest and clear-thinking economist who like to tell things as they are. But why now, and why so loud? Advisers to presidents, especially those with something worrying to say, tend to whisper it.

Another theory is that the Kremlin, where Mr Illarionov works, is preparing the ground for a government reshuffle. A leading casualty in that might be the prime minister, Mikhail Kasyanov, who is a master of bruising debt negotiations, but shows little understanding of economic reform. Other government ministers, better known for their personal financial planning than for their political abilities, face the chop, too.

A third explanation is that Mr Illarionov is fed up. Although he says he sees Mr Putin frequently, his own office is tellingly small and out of the way. His recent outbursts, coupled with a German threat to chuck Russia out of G8 rich-country summits, seem to have had some effect on Russia's approach to the Paris

Club. Mr Putin has told the government to think about how it can pay, and there are signs that this year's budget may be revised to try to find the money. Yet there is little sign of serious reform elsewhere. "I'm always hoping to be sacked, and I'm disappointed to be here still," says Mr Illarionov. Perhaps he is joking, perhaps not.

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Economics focus

The difference that choice makes

Jan 25th 2001
From The Economist print edition

When American parents exercise choice in education, interesting things happen: public schools work better, demand for private schools subsides, good teachers do well and bad ones don't

THE prospects for school vouchers in America, to create a kind of market in publicly funded education, look bleak. President Bush had said he was keen on the idea, but the education plan he proposed this week fails to take the idea very far, and what little it proposes on vouchers seems certain to be dropped in the end (see article). This is a shame—or so, at any rate, some fascinating new work on the effects of school choice suggests.

Caroline Hoxby of Harvard University has been working on different aspects of this issue for some time. Ms Hoxby's work inspires a kind of awe among many economists: for its clarity, its empirical thoroughness, and its wonderful ingenuity in finding ways to answer hard questions. Even if school choice were an issue that did not matter, her work would be justly admired. And it so happens that school choice is something that matters a lot.

In theory, Ms Hoxby says in her most recent published work, the effect of parental choice on school-system performance is uncertain. On one hand, choice, leading to competition among schools, should encourage productivity, just as it does in other markets. On the other, schools may sort themselves in such a way that "good peers are not in contact with those who would benefit from them most", leaving the system as a whole worse off. That may be true; whether it would be a legitimate reason to deny choice seems doubtful—"you must stay in this bad school because you are helping other pupils" is not a liberal doctrine. Still, this plainly does have a bearing on the assessment of effects. Given the countervailing influences, whether choice improves education is an open, empirical question.

In answering it, Ms Hoxby begins by noting that (a) various kinds of school choice already exist across the United States and (b) one of these is especially susceptible to econometric investigation. Some cities have lots of school districts; some do not. In the first group, parents have greater effective choice than in the second: they can exercise it by moving more readily out of one district and into another, a process of choosing with your feet that economists call "Tiebout choice".

This, it turns out, is an econometrically promising idea. Often, policy on other kinds of school choice (as when, say, a district decides to let parents choose among schools within its area) is influenced by school performance. When that happens, cause and effect get muddled up: it is hard to know how much choice is affecting performance, and how much vice versa. But Ms Hoxby suspects, and confirms, that the number of districts in any area depends heavily on historical circumstances. In this case, causation runs mainly from choice to performance. (And to the extent that this is not so, she takes ingenious steps to allow for the fact and neutralise it.) The upshot is that Tiebout choice can be explored with confidence for its effects, one way or the other, on school performance.

Competition works

What then are the findings? Mainly, that choice improves performance. Achievement, measured by test scores and students' future earnings, is higher when there is more choice among districts. To see the scale, compare a city like Miami (at one extreme, with just one district covering almost all the metropolitan area) and Boston (at the other, with 70 districts within a 30-minute commute of

downtown): that big an increase in choice is associated with an improvement in attainment of 1.4 grades and an increase in young adult earnings of 15%. And remember that choice in this form is presumably a milder stimulus than would be choice in the form of, say, an adequately funded voucher scheme.

Four other results stand out. First, choice *reduces* spending on education—the improvement in performance is achieved at lower cost. Second, it has the biggest effects on school productivity in states where districts have greater financial independence. Third, it reduces demand for private education: "policies that reduce choice among districts (district consolidation) or the benefits of choice (more state control of spending) are likely to increase the share of students in private schools and reduce the share of voters who are interested in the general well-being of public education." Fourth, the effects barely differ as between prosperous families and poor families (or white families and black families). The view that greater choice favours the rich at the expense of the poor gets no backing. Everybody gains.

Except bad teachers. In another paper, Ms Hoxby provides an interesting footnote on the implications of greater choice for teachers—whose unions are, of course, trenchantly opposed to most ways of increasing competition among schools. Greater choice (measured more broadly now: the econometric issues are different) is found to increase the demand for teachers who are better qualified, or went to better colleges, or have good maths and science skills, or are willing to work longer hours than their contracts require. Note that schools which operate under greater choice do not necessarily pay their teachers more (charter schools, for instance, pay less than average), but what they pay varies more with teacher quality. Such schools retain well-qualified teachers for longer than do schools facing less choice.

Choice appears to have much in its favour. Everything, maybe, except to the lower orders of the teaching profession and the massed ranks of elected politicians.

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Economics focus

The difference that choice makes

Jan 25th 2001
From The Economist print edition

When American parents exercise choice in education, interesting things happen: public schools work better, demand for private schools subsides, good teachers do well and bad ones don't

THE prospects for school vouchers in America, to create a kind of market in publicly funded education, look bleak. President Bush had said he was keen on the idea, but the education plan he proposed this week fails to take the idea very far, and what little it proposes on vouchers seems certain to be dropped in the end (see article). This is a shame—or so, at any rate, some fascinating new work on the effects of school choice suggests.

Caroline Hoxby of Harvard University has been working on different aspects of this issue for some time. Ms Hoxby's work inspires a kind of awe among many economists: for its clarity, its empirical thoroughness, and its wonderful ingenuity in finding ways to answer hard questions. Even if school choice were an issue that did not matter, her work would be justly admired. And it so happens that school choice is something that matters a lot.

In theory, Ms Hoxby says in her most recent published work, the effect of parental choice on school-system performance is uncertain. On one hand, choice, leading to competition among schools, should encourage productivity, just as it does in other markets. On the other, schools may sort themselves in such a way that "good peers are not in contact with those who would benefit from them most", leaving the system as a whole worse off. That may be true; whether it would be a legitimate reason to deny choice seems doubtful—"you must stay in this bad school because you are helping other pupils" is not a liberal doctrine. Still, this plainly does have a bearing on the assessment of effects. Given the countervailing influences, whether choice improves education is an open, empirical question.

In answering it, Ms Hoxby begins by noting that (a) various kinds of school choice already exist across the United States and (b) one of these is especially susceptible to econometric investigation. Some cities have lots of school districts; some do not. In the first group, parents have greater effective choice than in the second: they can exercise it by moving more readily out of one district and into another, a process of choosing with your feet that economists call "Tiebout choice".

This, it turns out, is an econometrically promising idea. Often, policy on other kinds of school choice (as when, say, a district decides to let parents choose among schools within its area) is influenced by school performance. When that happens, cause and effect get muddled up: it is hard to know how much choice is affecting performance, and how much vice versa. But Ms Hoxby suspects, and confirms, that the number of districts in any area depends heavily on historical circumstances. In this case, causation runs mainly from choice to performance. (And to the extent that this is not so, she takes ingenious steps to allow for the fact and neutralise it.) The upshot is that Tiebout choice can be explored with confidence for its effects, one way or the other, on school performance.

Competition works

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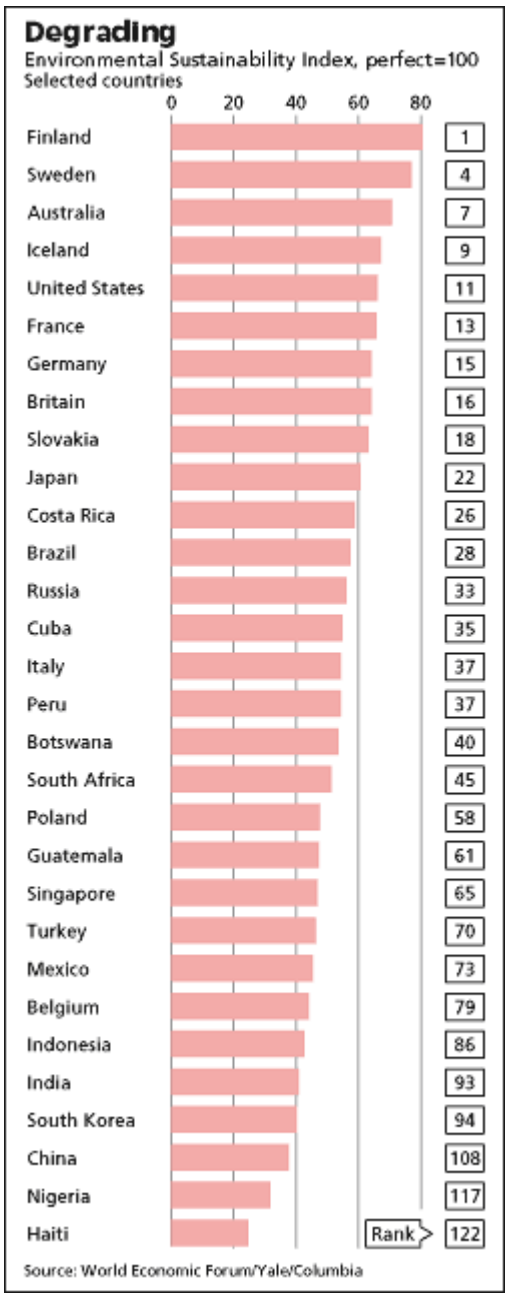
Sustainable growth

Green and growing

Jan 25th 2001
From The Economist print edition

What is environmental sustainability, and how can you measure it?

HOW are prosperity and greenery related? It has been a combative and so far undecided issue among environmentalists and economists, made the more so by the poor quality of most environmental data. Now a team led by Dan Esty of Yale University, with support from Columbia University and the World Economic Forum (WEF), hopes to fill that information gap, and perhaps to help answer the broader question, too. Their team has developed the Environmental Sustainability Index (ESI), a detailed assessment of dozens of variables that influence the environmental health of economies (see chart). The team released its rankings of 122 countries this week, to coincide with the forum's schmoozathon of businessmen and political leaders at Davos, in Switzerland. The devil is, of course, in the detail. For a start, defining "environmental sustainability" is a tricky task, on which the rest of the exercise hangs. The researchers point out that politicians have bandied the term about for years, but have not thought to measure it—though it is less woolly than the (no less bandied-about) idea of "sustainable development".



Mr Esty and his researchers sorted through 67 separate variables that it reckoned could influence environmental sustainability, ranging from sulphur dioxide in the air to corruption. They devised 22 "core" indicators for the ESI, made up of those variables, which they weighted equally for the purpose of the country rankings. These range from eco-efficiency, to population stress, to the responsiveness of the private sector. They found that the indicators clump together naturally into five broad areas:

•**Environmental systems**. This assesses whether biodiversity and other measures of environmental well-being are at healthy levels, and whether they are improving rather than deteriorating—for whatever causes.

•**Reducing environmental stresses**. This judges whether human impact is low enough not demonstrably to harm environmental systems.

•**Reducing human vulnerability**. This measures how susceptible people's basic needs (such as health and nutrition) are to environmental disruptions.

•**Social and institutional capacity**. This weighs up whether the country has in place institutions and underlying social patterns of skills needed to cope with environmental challenges.

•**Global stewardship**. This considers whether countries work well on cross-border issues such as global warming, ozone depletion and acid rain.

Quantitative quagmire

What light does the new ESI report shed on all this? One finding is that there is considerable variation in environmental sustainability among countries at similar stages of economic development. Wealth certainly matters: per-head income is highly correlated with the ESI'S rankings. It is absurd to expect Haiti, which is deforested, to pursue green goals as keenly as Finland. But there is no reason it should not aspire to the relative greenery of comparably poor Cameroon.

A striking result is that the variable with the greatest correlation with greenery is corruption: the less corrupt a country is, whatever its income level, the more likely it is to score high in the rankings. Mr Esty reckons that corruption (measured by Transparency International, an anti-corruption group) is a proxy for lots of other things, such as the rule of law and the protection of property rights, that have a big influence on how individuals treat natural resources.

Interesting, yet nagging doubts remain about the methodology. For a start, one inevitable doubt that any such country-by-country analysis faces is that environmental problems rarely fall neatly within a single country's boundaries. Problems may be global or cross-border—or even highly local—in nature. Another doubt about country rankings is that headline-grabbing hype may overshadow the substantive analysis that backs up such rankings.

A tricky challenge for the cross-country comparisons is to decide how to weigh each indicator. Global warming may mean a lot to Finns, but people in the poor world's filthy cities care much more about local air or water pollution (see table). The ESI gives equal weight to all its 22 indicators, an approach that is sure to please no one. The authors accept this criticism, but explain that their database will soon be available on CD-ROM. Critics will then be able to use whatever weightings they prefer.

Gasping

Willingness to pay 10% more for petrol to reduce air pollution, % strongly agreeing

India	65	Britain	31
Venezuela	63	United States	27
China	45	Thailand	18
Mexico	39	South Africa	18
Germany	33	France	17
Russia	32	Japan	13

Source: Environics International

Another challenge remains the paucity of good data. By forging ahead anyway, the report risks lending a quantitative gravitas to conclusions that are based on still-sketchy data. The researchers sometimes used computer models; at other times, they made educated guesses. Huge data gaps remain in areas such as toxic waste, lead poisoning and natural-resource subsidies. The authors justify this by arguing that they have created a framework that exposes the data deficiencies, and so spurs others to remedy them. Future versions of the report, they point out, can only get better.

One of the more surprising findings of the rankings is the low score received by Singapore, which prides itself on being the "garden city of the east"—and on coming at or near the top of most international rankings. Equally surprising may be the relatively high score for Russia, infamous for its pollution inherited from the Soviet era. In Singapore's case, the authors reject suggestions that a heavily populated city-state crammed on to a small island meets unduly harsh judgment. On the contrary, they point out, their framework is weighted towards only countries' populated parts, so that countries with large, empty tracts, such as Russia, are not unfairly rewarded. That is why their analysis in general shows only a weak link between ESI score and land area. Ditto, population density.

Yet even after such adjustments, Singapore scores poorly, because its environmental situation is precarious. The authors argue that they wish to illuminate precisely how such places are approaching the limits of environmental sustainability. In Russia's case, the authors acknowledge, the ranking is surely inflated. They point to faulty and missing data as the culprits. They have tried to fill in some gaps, but they have not replaced even dubious official sources of data with unofficial ones, fearing the poor precedent: it would be impossible to replicate for all countries.

As that unsatisfying compromise highlights, the ESI is deficient in several important ways. Alas, it also does not provide a definitive answer to the really big questions about the causal linkages between greenery and growth. However, Mr Esty argues, "the chief virtue of this index is that it begins the process of shifting environmental debates on to firmer foundations, underpinned by data and a greater degree of analytic rigour." On that more modest measure, the ESI is a thoughtful step in the right direction.

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The scent of a scam

Jan 25th 2001 | NEW YORK
From The Economist print edition

DRIVING in New York is war, casualties frequent. What better recovery for a car accident's unfortunate victim than to lie in a darkened room, inhaling the sweet smells of pungent lotions? And what better still than to get somebody else to pay for it?

In recent months, the claims department at a large property-casualty company has been getting a growing stream of claims for these services, known as aromatherapy. "It is a new, creative outgrowth of the never-ending cycle to treat innovatively at our expense," grumbles the claims manager of the company which, given the onslaught of innovation, is bashful about revealing its name.

Demand for aromatherapy follows the increased popularity of other "alternative" treatments—techniques that are not often taught in schools of western medicine. Among the most common are acupuncture, massage, and chiropractic services. At the very least, it can be a pleasant way to spend an afternoon. It may even help. "Soft-tissue" injuries, particularly those around the neck, are notoriously hard to diagnose and repair with any precision. With great gaps in knowledge still remaining, medicine remains part-art. Do insurance companies really know where to draw the line between scam and need?

Suffice to say that they would like to try. What angers the insurers about the legal status of treatment in New York is that many claims must be paid, no questions asked. Far from being pre-approved, bills are submitted months after the "treatment" has taken place. The "personal injury protection" portion of New York's no-fault car-insurance law is unpermissably permissive, in contrast to tough policies set in other states.

Perhaps it is not surprising that claims under New York's generous policy are 44% higher than the national average, according to the New York Insurance Association. These higher costs, it goes without saying, translate into higher premiums. Don't bother fretting about this. Call it an accident of fate, and try breathing deeply.

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Making the complex simple

Jan 25th 2001 | SANTA FE
From The Economist print edition

In the early 1990s, the science of complexity made a big noise but cast little light. Now its chastened practitioners are having another go

MOST of the things that go on in the world seem intractably complicated—far too difficult ever to be able to predict. The stockmarket, the weather, human behaviour, life and so on all seem to suffer from a refusal to submit to prophesy. Because so much of the world that interests people works this way, science is now asking a question that seems paradoxical: is there anything simple about complexity?

Complexity research has attracted a lot of attention, but the field remains contentious. In the early 1990s, a wave of work in the field concentrated on computer-based experiments that were novel, but not clearly relevant to the real world. Complexity science promised much, but ultimately delivered relatively little. Many therefore dismissed it as mere handwaving.

To try to change this image, a workshop held earlier this month in Santa Fe, New Mexico, and sponsored by the Institute for Complex Adaptive Matter, gathered together a diverse group of researchers. Their task was to examine the ways in which complex systems are similar to one another, and the ways in which they differ, and to try to work out how that knowledge might be used to conduct experiments that would illuminate real problems.

Stooping to conquer

Part of this new-found humility on the part of the gurus involves trying to understand the complexities of relatively simple systems. Some early complexity researchers used to think they could solve life at one go. John Sarrao, of Los Alamos National Laboratory, is content with studying correlated-electron matter.

This form of matter is different from the more familiar type, in that the properties it exhibits (notably superconductivity) result from many of its electrons organising themselves collectively. A single atom of copper is still a piece of copper. But there is no such thing as a single atom, or single electron, that is superconducting. That makes correlated-electron matter a complex system. And because superconductivity has practical applications (it means that an electric current can flow without resistance, albeit only at very low temperatures), it is worth studying.

The magnetic and conducting properties of the materials that Dr Sarrao is examining are intimately connected—a surprise, since superconductivity and magnetism are usually thought of as antithetical to each other. Traditional superconductors are metals. These superconduct only when cooled to a temperature near absolute zero. But those magnetic and conducting properties turn out to be the same in a wide range of different correlated-electron materials, including so-called “high-temperature superconductors” (which are made of ceramics, and do their stuff in the relatively warm embrace of liquid nitrogen), and a group of organic molecules that also superconduct at relatively high temperatures.

According to Dr Sarrao, if the essential elements that give these seemingly different materials similar properties could be extracted, a model of superconductivity that transcends specific materials could be constructed. That might make it possible to design from scratch substances with particular features—things that superconduct at room temperature, for example.

This desire to find essential elements in common extends to searching for deep parallels between physics and biology. Computing, for example, is traditionally the province of physicists. The electrons and photons used for data processing are certainly part of their realm. But cells process data, too. And Robert Laughlin of Stanford University proposes an interpretation of the way that DNA (the material in a cell's nucleus of which genes are made) is transcribed into RNA (the material that carries the message of the genes to the rest of the cell) that might be the basis for a kind of binary digital computation in cells that biologists have not thought of before.

Other bits of biology are coming under the complexity folk's scrutiny. James Shapiro and his colleagues at the University of Chicago have been studying a common gut bacterium called *Proteus mirabilis*. As they migrate over solid surfaces, colonies of *Proteus* produce astonishingly beautiful, circular, terraced structures. Dr Shapiro has found that these patterns are not actually functional. Instead, they are an "emergent property" that results from a simple strategy that the bacteria use to escape from their neighbours and thus to avoid overcrowding. That may sound esoteric, but the results should help researchers to understand the ways that bacteria spread in nature, illuminating problems as diverse as disease, water treatment, corrosion, and the formation of certain metal ores.

All good, practical stuff. But some old dogs cannot be taught new tricks, and the "what is life" question is not going to go away that easily. George Whitesides and his colleagues at Harvard University have been investigating it, by making models of some of the attributes of living things.

One thing that all the processes of life seem to have in common is that they dissipate energy to create order. In the spirit of connecting diverse fields, Dr Whitesides is trying to replicate this phenomenon, not in biochemistry, but in mechanics. He and his group are scattering collections of tiny objects such as metal discs and beads a millimetre or so across on dishes of liquid, and spinning them with magnetic fields. The idea is to see whether such primitive "systems" can spontaneously generate some sort of order, and whether such order is predictable.

Some of the patterns produced are, indeed, predictable from the existing laws of mechanics. But others are totally unexpected—another example of emergent properties. According to Dr Whitesides, the whole point is to design systems that do something new, and then to learn from them. He would like to understand a set of such systems well enough to be able to build feedback into them. That, he reckons, should allow the patterns to "evolve"—another characteristic of living things.

An artificial creature made of metal discs and beads may be stretching the imagination a bit. But even the newly practical men and women of complexity need to be allowed a bit of fun. Whether they will ever be able to predict the vagaries of the stockmarket is a different question. But if you see one of them on a sudden spending spree, you may draw your own conclusions.

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Topology and neurology

Navigating your mind

Jan 25th 2001 | NEW ORLEANS
From The Economist print edition

A 19th-century mathematical technique is making it possible to map the details of people's brains

YOUR neurologist would love to flatten your brain. Not physically, you will be glad to know, but mathematically. For, just as the exploration of the earth's surface (a sphere, more or less) required the creation of appropriate flat maps, so, too, does the exploration of the surface of the brain.

It is not that hard to convert a sphere into a plane, provided that you are clear about the compromises you are prepared to make. The Mercator projection, for example, preserves shapes and angular relationships at the expense of areas—so that the polar regions look far too large in relation to the equatorial ones. Flattening out the convoluted surface of the brain requires more compromises than that. But Monica Hurdal of Florida State University thinks that she has made them in an acceptable way. At the recent joint annual meetings of the American Mathematical Society and the Mathematical Association of America in New Orleans, she presented her work on "quasi-conformal maps of the human brain from circle packings".

Brains do most of their information-processing on the surface—or cortex, as it is known neurologically. So species that, in the course of evolution, have come to need more brain-power, have developed brains with creased, convoluted cortexes that pack more surface area into the same volume of skull. This makes it hard for researchers to see exactly which parts of the cortex are doing what, and how they are related to one another. So, although it is possible to put somebody into a brain scanner, set them a task, and see which bits of their cortex light up with activity, areas that look adjacent in an image produced by the scanner may, if they have a deep fold between them, actually be a long way apart.

That is where a map—a flattened version of the brain showing exactly where on its surface the activity is taking place—would come in handy. It would, for preference, be a projection that preserves shapes, like Mercator's. And this is indeed possible, according to Dr Hurdal, using a law of geometry known as the Riemann mapping theorem that was first enunciated in 1854.

This theorem says that every continuous surface can be turned into a special kind of flat map, called a conformal map. Such a map means that if you have two angles on the original surface, and one is twice as large as the other, the first angle will remain twice as large as the second even if the actual number of degrees in each angle changes. This is not quite as good as keeping every angle the same, as with Mercator's projection, but it is good enough for neurologists who want to steer between bits of the cortex.

To prove her point, Dr Hurdal showed her audience a map of part of the brain, called the cerebellum, of a hapless student who had been induced to undergo no fewer than 27 brain scans. The upshot of this scanning was a high-quality three-dimensional image, to a precision of one millimetre in each direction. This level of precision allowed her to distinguish precisely between the "white" matter of the brain's interior, and the "grey" matter of its cortex. The result was a network of 50,000 cortical points, each connected to its nearest neighbours by a line. Dr Hurdal thus ended up with a landscape, still convoluted, of triangles.

The hard part was flattening this network of triangles. But an older theorem, going back to the ancient Greeks, states that you can always draw three circles around the corners of a triangle so that each one just touches the other two. Since any two of these circles will also belong to a neighbouring triangle, if you have thousands of triangles in a flat plane, you can have a perfect packing of that plane by thousands of circles.

Unfortunately, the triangles that represent the surface of a brain are not in a flat plane, so the touching circles drawn in each of them will stick out. But there will still, according to the Riemann theorem, be a unique way to move all the points until they settle down with the circles into a well-packed plane. The result is, to a good approximation, a conformal map.

Navigation, however, also requires a reference grid. On the earth's surface, this is derived from two fixed points (the poles) and a line (the equator). In the cerebellum, the equivalents of these have to be bits of anatomy that can be recognised in everybody's version of the structure. Fortunately, although much about the cerebellum is mysterious, enough is known for such features to have been identified.

Once brain-navigation becomes routine (with luck, without the need for 27 separate scans), it will be possible to track changes in a brain over time. It will also be possible to compare the brain maps of individuals, even if everyone's cortex is folded slightly differently. And that should lead to some interesting voyages of neural discovery indeed.

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About sponsorship

Recycling

In the black

Jan 25th 2001
From The Economist print edition

TELEVISIONS. Car bumpers. Computers. Telephones. They may be a bit more expensive than your typical soft-drink bottle, but their plastic is just as recyclable. Until recently, though, only the bottles have tended to be recycled. With good reason: each bottle is made of only one type of plastic, which makes them easy to sort and profitable to reuse. The mixture of plastics in more complicated goods poses problems.

Consumer-electronic devices, such as telephones, are made up of as many as 15 different kinds of plastic. A black plastic, say, for the case; a different black plastic for the numbered buttons; a grey plastic for the “redial” button; and so on. Taking apart and sorting these would be time-consuming enough even if all that had to be done was to separate by colour. But plastic must be sorted by its chemical composition as well, and this is where the biggest problem lies. It is also where Edward Grant comes in. Dr Grant is a chemist at Purdue University in Indiana, and also boss of a company called SpectraCode. He and his colleagues have created a device that can sort plastics, black or otherwise, according to their chemical composition—and in as little as a hundredth of the time required by today’s sorting methods.

Each type of plastic has its own signature. This is its “absorption spectrum”—a pattern of frequencies of infra-red light, invisible to the eye, that is absorbed when the rest is reflected from its surface. Traditional plastic-sorting devices exploit these signatures to determine what type of plastic something is made of. But black things absorb so much light that conventional sorters cannot distinguish among them. The easiest thing, therefore, is to throw them away.

The second-easiest, however, is to delve further into the infra-red spectrum. Here, plastics that are black to the eye actually reflect a reasonable amount of light, so it is possible to get a meaningful absorption spectrum. Some sorters work this way. But they have problems. This sort of “mid-infra-red” light is hard to generate as a powerful beam, and the detectors available to analyse it are less sensitive than those used for infra-red that is nearer to the visible spectrum. So each item has to be scanned for a long time—sometimes as long as seven seconds—to obtain a meaningful result. The plastic must also be flat and smooth for the reading to be accurate, and the object must be brought to the machine (which is not very portable) for analysis, which takes yet more time.

Dr Grant first tried to overcome this with a point-and-shoot system, in which he brought the analyser to the plastic instead. Using an instrument similar to the scanning bar-code guns at supermarket checkouts, this machine analyses black plastics with a laser. The laser beam in the scanner shoots a steady stream of photons, all of the same frequency, at the plastic. One photon in a million comes away with a different frequency from the one that it arrived with because it changes the structure of a chemical bond in one of the plastic’s molecules. That new frequency therefore depends on the composition of the plastic.

With this early model, the laser had to be set on low power to stop the plastic overheating, or even catching fire. That reduced the number of photons emitted every second, thus increasing the time it took to analyse an object to ten seconds. But SpectraCode’s new probe employs a technique that Dr Grant calls “distributed focusing”. With this, the scanning beam is not directed at any single spot, but moves around, so the plastic does not burn. That means the laser can operate at a much higher power, and thus get a result faster. Like the earlier model, this version can be used on plastics of any colour, but it is particularly good at dealing with the black stuff. Unlike the earlier model, it recognises the plastic that it is pointed at in a tenth of a second.

Although the new device has yet to hit the market, SpectraCode has already begun taking orders for it, and will deliver the first shipment in early April. That could be good news all round. The faster a plant can identify and sort its plastic, the more money it should make—giving it a much better chance of operating

in the black.

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Cor, you don't half smell

Jan 25th 2001
From The Economist print edition

DID you dab on a little cologne this morning? Using scent to make yourself more attractive is nothing new. People have been dousing themselves with fragrances since at least the time of the ancient Egyptians. But, perhaps surprisingly, nobody really knows why.

The general assumption is that perfume is a form of olfactory camouflage for foul body odour. But research by Manfred Milinski of the Max Planck Institute in Ploen, Germany, and Claus Wedekind of the University of Edinburgh, to be published soon in *Behavioral Ecology*, suggests the reason could be the opposite: to underscore a person's existing smell.

Dr Milinski and Dr Wedekind asked 137 students (of both sexes) at the University of Bern to sniff a range of 36 odours. These included such familiar fragrances as rose and geranium—but also more exotic ones such as ambergris, a substance regurgitated from the intestines of sperm whales, and musk, which is scooped from an Asian deer's abdominal gland, both of which are prized perfume ingredients.

The students were asked to decide if a particular fragrance was suitable for themselves, ranking it from "pleasant" to "unpleasant". Then they were asked to repeat the experiment, this time asking whether each smell would be appealing on a mate.

Previous work has shown that a cluster of genes called the major histocompatibility complex, or MHC, helps to determine body odour. The MHC is part of the immune system, and varies from individual to individual, although relatives have more similar MHCs than do the unrelated.

In mice, individuals are known to use this information when they are choosing mates—presumably to avoid inbreeding. And in the past Dr Wedekind has found evidence suggesting that this may be true of people, too. He and Dr Milinski therefore took blood samples from their volunteers, in order to analyse their MHC genes. They reckoned that, if people were choosing perfumes to augment their own natural smells, then those with similar MHC genes would tend to prefer the same scents.

And that is precisely what they found. The results were strongest for those who had the genes known as HLA-A1 and HLA-A2 in their complexes. People with HLA-A1, for example, tended to dislike ambergris and musk, while those with HLA-A2 rather liked them. There was no association, however, between a person's MHC and the kind of scent they preferred to smell on a mate—a reasonable observation, according to Dr Milinski, since anything other than "self" could smell appealing on a partner.

These results are quite in keeping with perfume history, according to Dr Milinski. In medieval times, professional perfumers would concoct personal scents for their clients from six to eight special ingredients. A daughter would inherit a few of those ingredients from her mother. He also points out that, despite the fact that perfume companies come out with new products every year, the ingredients remain largely unchanged—and still include many substances identified in Biblical perfume recipes. That which we call a rose, by any other name might smell as sweet. But only if the right person is wearing it.

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About sponsorship

A long and winding trip

Jan 25th 2001
From The Economist print edition

Hollywood, for good or ill, acts as educator as well as entertainer. It has never worked out a clear message on drugs

VLADIMIR NABOKOV, who understood Hollywood's appetite for happy endings, once remarked that there were nevertheless two plot-lines that it would not tolerate. One was the marriage of an inter-racial couple who live happily ever after. The other was the story of a confirmed atheist who dies painlessly in his bed at the age of 102 after a full and fruitful life, surrounded by children and grandchildren. The great writer could easily have added a third Hollywood taboo: the gainfully employed drug taker who does so because he likes to, and isn't either cured of his habit or punished for it by prison, disgrace or ill-health.

Ronald Grant Archive

Nabokov, it has to be said, was talking 40 years ago, and there are signs that Tinseltown is changing, at least in regard to the supply-side of drugs. A much-talked about new film, "Traffic" (see article), continues to present users as foolish or doomed. But it depicts America's paramilitary campaign against narcotics as wasteful, if not lost. The police and the Drug Enforcement Agency are seen fighting at moral and material cost to protect values to which many Americans, it is suggested, no longer subscribe.

From the silent era, when few police adventures were complete without a chase through a Chinatown opium den, Hollywood has treated drugs with an unstable mixture of fear and fascination, moralism and concern. In 1930 came outright denial in the form of a self-censorship code which, among other strictures, forbade depiction of drug takers or makers in any light whatsoever. Film producers almost all complied. Even in Sherlock Holmes films you had to be a detective yourself to intuit that the demon sleuth liked cocaine.

"Narcotic" (1933), made outside the studio system by Dwain Esper, is one of two 1930s pictures that blatantly flouted the production code, masking exploitation with a veneer of social concern. The film made the startling claim that America had 1m known addicts, at a time when drugs were hard to come by. Purportedly the biopic of an opium-crazed snake-oil salesman, "Narcotic" was really an excuse to depict a dope party, where addicts snort, inject, flash their knickers and are reduced to helpless giggles. Similarly in "Reefer Madness" (1936) smoking marijuana leads to such well-known consequences as uncontrollable twitching and eye-rolling sexual rapacity.

Tosh of this kind is a natural by-product of censorship. When, in the mid-1950s, a few film makers decided to break the code, ignorance showed. For all its apparent courage—and justly famous credit titles by Saul Bass (see picture)—Otto Preminger's "The Man with the Golden Arm" (1955) sensationalised its subject. Frank Sinatra plays a junkie musician who undergoes a cold-turkey detox. The film was also careful to observe Hollywood's broader moral conventions: Sinatra is punished (he has to settle for work as a poker dealer) yet the film ends happily (he is cured). Commercially speaking, the film was a gamble. Preminger calculated, correctly, that a hot subject and the presence of Sinatra, whose career was on a rise again after an Oscar in "From Here to Eternity", would oblige exhibitors to disregard the production code and book the film regardless. (The code limped on until 1968, when it was replaced with ratings.)

Nor was it just with narcotics that Hollywood often found itself working in the dark. Experimental medicines, the subject of Nicholas Ray's "Bigger than Life" (1956), were feared and misunderstood: when James Mason is prescribed a course of cortisone, he becomes a homicidal maniac with murderous designs on his son.

For all their weaknesses, films of this kind introduced the thought that drugs might be more a medical than a criminal issue. “Monkey on My Back” (1957) was about a boxer-addict and war veteran who had been given morphine for malaria on Guadalcanal. Vietnam war films such as “Apocalypse Now” (1979) pursue the idea of drugs as a normal response to the abnormal. In “Platoon” (1986) soldiers get stoned to make the war endurable.

By contrast, Hollywood resisted portraying drugs as a diversion from daily life. In Shirley Clarke’s “The Connection” (1961), from a Jack Gelber play complete with jazz accompaniment, drugs are part of the hipsters’ lives. But not everyone would have thought of those lives as ordinary, and the film, besides, was not a Hollywood product. Roger Corman’s “The Trip” (1967), which was made for Hollywood, did attempt to convey the psychedelic experiences of an LSD tripper. Perhaps “Easy Rider” (1969) came closest to normalising everyday drug taking. Such films from the late 1960s and early 1970s were testing how far they could go. Even so, there was usually a homily of some kind at the end.

Not all Hollywood films, of course, are message pictures. Drugs are a great plot device. The Oscar-winning film “The French Connection” (1971), about a dogged drugs sleuth, could really have been about anything (diluted penicillin, weapons-grade plutonium?) so long as the smugglers could be safely presented as dangerous and dispensable. (A cop who is hooked is a still more interesting character, and in “French Connection II” (1975), Popeye Doyle, played again by Gene Hackman, has turned junkie.)

Tinseltown has not yet gone down the road of Britain’s “Trainspotting” (1995). In its opening scene, Ewan McGregor, fleeing the law, delivers a straight-to-camera monologue on the run, rubbishing everything about society from earning a living to banning drugs. With the addict’s fix celebrated as life’s greatest experience, “Trainspotting” was one of the most unsettling and subversive films of the 1990s.

On the other hand, doubts about the drugs war, which were murmured in “Midnight Express” (1978), were clearly voiced in “Brokedown Palace” (1999). In each film, a tourist caught drug-smuggling in foreign parts gets a long prison term. In “Brokedown Palace” the accused is framed. But both stories treat the prisoner as guiltless and put the criminalisation of drugs in the dock.

Against this shift in attitudes, conventional drugs thrillers no longer work. When Spike Lee made “Clockers” (1995), a narcotics adventure, he showed a Brooklyn police force all but overwhelmed. “Traffic” amplifies this theme, implying with filmic exaggeration that society is being engulfed by smugglers and anti-drug warriors alike. No Hollywood film has yet called for the legalisation even of soft drugs and the “Trainspotting” figure of the happy addict (itself a fantasy?) is as far from American films as it ever was. But if “Traffic” is any sign of where Hollywood is headed in its winding trip with drugs, more films may soon be saying that the cure is now worse than the disease.

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Heavy “Traffic”

Jan 25th 2001
From The Economist print edition

STEVEN SODERBERGH, in “Traffic”, aims for a wide-angle view of the American drugs scene, with three parallel but barely connecting storylines intended to convey the enormity of the drugs issue and to suggest that America’s war against drugs is being lost. One story involves policing the United States-Mexican border, one the efforts of an arrested drug baron’s wife to win back her comfortable way of life, and the third the discovery by a narcotics overlord that his own daughter is addicted. The structure comes from a British TV mini-series of the 1980s with the same name, updated to a contemporary American context.

Even at two and a half hours, however, entire aspects are overlooked. “Traffic” shows the pushers, the users and the war, but nothing about teaching young drug-takers to distinguish safe from not safe, nor about the supply lines to the dealers and the widespread corruption or tacit government support in producing countries. “Traffic” is a drama, after all, not a documentary or a newspaper editorial. Yet half-developed views on many aspects of drugs underlie much of the plot, without being articulated.

What Mr Soderbergh does achieve, wearing his pseudonymous hat as the cameraman “Peter Andrews”, is a hand-held visual texture that distinguishes the American scenes from the Mexican ones by colour coding. In the American sequences, a wintry blue filter washes across the screen as if there were no end to misery; south of the border, it is all golden filters, as drug runners make a mockery of overworked and underpaid cops.

The script, however, struggles to fashion a coherent narrative out of a theme that perhaps needed four hours. And some scenes beggar belief. Would a parent, even a drugs tsar (Michael Douglas), snatch his daughter from the classroom and drag her across town in search of her drugs supplier? And could a gangster’s wife (Catherine Zeta Jones) turn overnight from frivolous lady-who-lunches into a ruthless killer?

“Traffic”, an Oscar possibility that is in contention at the Berlin film festival, is doing well, not brilliantly, at the box office.

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Computer technology

Authentic hero

Jan 25th 2001
From The Economist print edition

REBEL CODE: LINUX AND THE OPEN-SOURCE REVOLUTION
By Glyn Moody

Perseus Publishing; 334 pages; $27.50.
Allen Lane, The Penguin Press; £12.99

Buy it at
Amazon.com
Amazon.co.uk

Get article background

AP

The Robin Hood of operating systems

WHEN, during its antitrust trial in 1999, Microsoft had to name some competitors to prove that Windows was not a monopoly, it could point to just two. One was its old enemy, Apple, which had been briefly resurgent under Steve Jobs but these days was utterly dependent on Microsoft's willingness to carry on producing a version of its Office software that would run on the Mac operating system. The other was Linux, a free operating system that was the product not of a rival company, but of the work of thousands of anonymous hackers choreographed by a young Finnish student called Linus Torvalds.

In truth, Linux as an operating system for desktop PCs provides as little real competition to Windows as poor old Apple. That may come, although it is far from certain that something made for geeks by geeks will ever win widespread acceptance among consumers. But in the vital market for the operating systems that run the millions of small-to-medium-sized server computers that offer web-pages, handle e-mail and do countless other routine administrative tasks, Linux is already more ubiquitous than equivalent versions of Windows. Even more worryingly for Bill Gates, Linux, actively supported by powerful companies, such as IBM, Dell and even Intel, is getting ready to move up the computing food chain and into the corporate data centre—which is precisely where Microsoft is determined its strategically vital and expensively developed Windows 2000 should prevail.

That something created by "hobbyists", as Mr Gates calls them, may be doing more to threaten Microsoft's hegemony than wealthy and aggressive rivals, such as Sun Microsystems and Oracle, is nothing short of revolutionary. This alone makes the story that "Rebel Code" tells important.

In its way, Linux and other open-source products are as disruptive to the "traditional" software business as is the Internet. The Internet and open source reinforce each other, the former making possible new models of collaborative working, the latter supporting the Internet's preference for open, non-proprietary standards. It is no accident that open source is better suited to developing reliable utility-type software than sophisticated applications.

The virtue of "Rebel Code" is that it largely eschews hype and is clearly written, if at times in rather technical prose. Its weakness is that it conveys little of the unfolding drama and not nearly enough of the personalities and motivations of the extraordinary people who have helped to shape the open-source movement: its spiritual father, the quasi-communist coder Richard Stallman; the libertarian polemicist

Eric Raymond whose love affair with free software is matched only by his passion for guns; or the enigmatic Linus Torvalds himself, who has guided Linux for ten years and who has become an authentic hero within a community that instinctively distrusts such things.

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What the world is reading

Jan 25th 2001
From The Economist print edition

JANUARY is usually a quiet month for publishers and booksellers. The important and high-profile new books appear in September and March. This perhaps goes some way to explaining the rather unremarkable contents of the current American and British bestseller tables.

Bestsellers

	AMERICAN FICTION	AMERICAN NON-FICTION
1	From the Corner of his Eye - *by Dean Koontz* Darkly comic thriller	Who Moved My Cheese? - *by Spencer Johnson* Million-selling self-help book
2	Roses are Red - *by James Patterson* Detective versus criminal Mastermind	Body for Life - *by Bill Phillips* Three months to total health
3	The Constant Gardener - *by John le Carré* Diplomat takes on pharmaceutical giant	The O'Reilly Factor - *by Bill O'Reilly* Reflections of a TV anchorman
4	Shadow of the Hegemon - *by Orson Scott Card* Fate of Earth rests on children	A Short Guide to a Happy Life - *by Anna Quindlen* Enjoying life's simple pleasures
5	Prodigal Summer - *by Barbara Kingsolver* Love in the Appalachians	Tuesdays with Morrie - *by Mitch Albom* Dying man's wisdom
6	The Mark: The Beast Rules the World - *by Jerry B. Jenkins and Tim LaHaye* Latest in the "Left Behind" series	Guinness World Records 2001 *Published by Guinness Media* Remarkable facts and feats
7	Code to Zero - *by Ken Follett* Space race, espionage, amnesia	Until Today! - *by Iyanla Vanzant* Daily devotions
8	Dr Death - *by Jonathan Kellerman* Assisted suicide and attempted murder	The Beatles Anthology - *by The Beatles* The ultimate Beatles guide
9	The Last Precinct - *by Patricia Cornwell* Medical thriller	Nothing Like It in the World - *by Stephen E. Ambrose* Building the transcontinental railroad
10	Riley in the Morning - *by Sandra Brown* Estranged husband tries again	Face Forward - *by Kevyn Aucoin* Make-up tips

	BRITISH FICTION	BRITISH NON-FICTION
1	The Brethren - *by John Grisham* Blackmail at the highest level	'Tis - *by Frank McCourt* Second volume of memoirs
2	Harry Potter and the Prisoner of Azkaban - *by J.K. Rowling* Convict on the run after trainee wizard	A Child Called "It" - *by Dave Pelzer* Coping with childhood abuse
3	Harry Potter and the Philosopher's Stone - *by J.K. Rowling* Harry starts wizard school	Wan2tlk?: Ltle Bk of Txt Msgs *Published by Michael O'Mara Books* Text messaging dictionary
4	Harry Potter and the Chamber of Secrets - *by J.K. Rowling* More wizardry and more Harry	Highway Code: 1999 *Published by the Driving Standards Agency* Rules of the road
5	Harry Potter and the Goblet of Fire - *by J.K. Rowling* Harry in wizard tournament	Return of the Naked Chef - *by Jamie Oliver* More recipes from celebrity cook
6	Irresistible Forces - *by Danielle Steel* Marriage on the rocks	Who Wants to be a Millionaire? *Published by Question Masters* Television quiz show tie-in
7	Adrian Mole: The Cappuccino Years - *by Sue Townsend* Adrian becomes a celebrity chef	Angela's Ashes - *by Frank McCourt* The author's early years
8	Man and Boy - *by Tony Parsons* Single dad has to grow-up	The Naked Chef - *by Jamie Oliver* Celebrity cook's recipes
9	Fortune's Rocks - *by Anita Shreve* Young girl, older man	True: The Autobiography of Martin Kemp - *by Martin Kemp* Reminiscences of a former pop star
10	Good at Games - *by Jill Mansell* Looking for love	Dr Atkins' New Diet Revolution - *by Robert C. Atkins* Diet plan

Sources: *Publishers Weekly*; Whitaker BookTrack — Book descriptions by *The Economist*

The fiction lists are predictably full of big-name thrillers and romance novels—the latest offerings from Patricia Cornwell, Dean Koontz and Danielle Steel among others. Barbara Kingsolver's fine novel "Prodigal Summer" adds a touch of class to the American list, which excludes children's books—hence no Harry Potter, popular as he is in America. The bespectacled young wizard dominates Britain's list.

There is a little more variety in the non-fiction lists. There are, of course, the requisite self-help books, from the decidedly old-fashioned ("Dr Atkins' New Diet Revolution") to the coolly contemporary ("A Short Guide to a Happy Life"). Spencer Johnson's "Who Moved My Cheese?" continues to mature nicely, while "Tuesdays with Morrie" has become an American pastime on any day of the week.

The British non-fiction list does, however, contain at least one eyebrow-raising puzzle. The “Highway Code” outselling a celebrity chef of Jamie Oliver’s standing? It sounds surprising. But, thanks to a highly successful marketing push by the Driving Standards Agency, the handbook is speeding recklessly off the shelves in supermarkets and newsagents across the country.

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Literary lives (1)

Heartache

Jan 25th 2001
From The Economist print edition

ACCORDING to this new biography, William Hazlitt was the greatest essayist in English letters. He inherited an anti-establishment outlook from the dissenting tradition into which he was born in 1778, but it is Hazlitt's humanity—both as a person and in his philosophy—which really stands out.

THE QUARREL OF THE AGE: THE LIFE AND TIMES OF WILLIAM HAZLITT
By A.C. Grayling

Weidenfeld & Nicolson; 412 pages; £25

Buy it at Amazon.co.uk

As a young man, he was excited by the French revolution, and he retained an idealised view of Napoleon to the end of his life. But his generous imagination was equally capable of appreciating the prose of a conservative thinker like Edmund Burke. This inclusiveness of thought sits well with what Anthony Grayling cites as Hazlitt's most important contribution to philosophy: his belief not merely in the possibility of altruism but that human beings are essentially "naturally disinterested", not the selfish brutes that Thomas Hobbes perceived them to be.

Philosophy and politics took up much of Hazlitt's mental landscape, but his love of the theatre, expressed in his work as a drama critic, is where he is at his most appealing. "My God...Who is this Schiller, this convulser of the heart?" he wrote as a student. His mature writings on Shakespeare pay testimony to his continued ability to be deeply moved: over-intellectual modern-day critics should take a lesson from his capacity to write intelligently about emotion.

Yet for all the wisdom of his criticism, Hazlitt was not in control of his own emotional life. At the age of 42, having separated from his wife, he became infatuated with his landlord's daughter to an extent which can only be described as pathological. Unremarkable in herself, and apparently uninterested in him, the girl had a blankness about her on to which Hazlitt projected his own hell of lust and jealousy, passion and paranoia: at one point he even used a decoy to tempt her into sexual indiscretion and was rewarded with the agony of detailed descriptions of another man's hand up her skirt. The psychological toll on Hazlitt was great. When Mary Shelley saw him after a gap of three years, she could not believe how emaciated he had become.

Yet while this mad love affair, which Hazlitt chronicled and published as the embarrassing "Liber Amoris", reveals the flaws of the man, it also provides the part of the biography in which he comes most to life. That a man of such prolific mental powers should be in thrall to such an adolescent obsession only serves to highlight his humanity.

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Literary lives (2)

Heritage Hall

Jan 25th 2001
From The Economist print edition

THE BRONTË MYTH
By Lucasta Miller

Jonathan Cape; 336 pages; £18.99.

Buy it at
Amazon.co.uk

THERE are two books here. One is the story of how the Brontë family has been sentimentalised by the heritage industry and how the parsonage in Haworth, Yorkshire, in which they lived, has become a tourist destination. The other is the story of how literary critics have taken Charlotte, Emily and (to a lesser extent) Anne, and turned them and their writings into whatever the changing times seemed to require.

As a result of Mrs Gaskell's partial 1857 biography, Charlotte has come to be seen as a paragon of Victorian fortitude in a household of "three lonely sisters playing out their tragic destiny on top of a windswept moor with a mad misanthropic father and doomed brother." Lucasta Miller, a reviewer in these pages, challenges Mrs Gaskell and those she refers to as "the purple heather brigade", and she considers how far Charlotte, who nursed a "secret desire to be for ever known", participated in her own canonisation.

Emily, by contrast, preferred obscurity. Following the publication of "Wuthering Heights" in 1847 she took exception to having her authorship revealed by her sisters. Charlotte did not stop there. Jealous of Emily's overpowering imagination, she ineptly rewrote some of her sister's poetry.

And what of Anne, who has never attained the iconic status of Charlotte and Emily? Ms Miller has rather less to say about her. Nevertheless, her research ranges widely and she draws to our attention "Withering Looks", a satirical piece of theatre by a company called Lip Service, who explained Anne's absence from their piece as being "due to government cuts".

It was Patrick Brontë who gave Mrs Gaskell permission to write a life of his daughter, Charlotte. He shrugged off the book's many inaccuracies with equanimity, and has been castigated as a savage parent ever since. But he is presented here as charming, relaxed and maligned. The girls' brother Branwell, meanwhile, is sometimes thought to have been the true author of "Wuthering Heights". Ms Miller has no truck with this—but hints that he may well have been Emily's model for Heathcliff.

Among writers, Virginia Woolf and Sylvia Plath are the obvious inheritors of the Brontë myth. Indeed, Woolf's first piece of journalism described a visit to the parsonage, and, after their marriage, it was a place of pilgrimage for Plath and Ted Hughes, who himself looked alarmingly like the descriptions Emily gives us of Heathcliff. But Ms Miller concludes: "It is time to turn the tables and put the writings first." Amen to that. "The Brontë Myth" is a genial and fascinating book, and a remarkable debut.

DAVID BENEDICTUS

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Evolutionary psychology

Bad behaviour

Jan 25th 2001
From The Economist print edition

ALAS, POOR DARWIN: ARGUMENTS AGAINST EVOLUTIONARY PSYCHOLOGY.
Edited by Hilary Rose and Steven Rose.
Harmony Books; 400 pages; $25.
Jonathan Cape; £18.99

ACCORDING to evolutionary psychology, most of our actions, emotions and beliefs—including the sexual attractiveness of Donald Trump, the popularity of cheeseburgers and the crime of rape—are the products of natural selection that acted on our savannah-dwelling forebears. This new notion of man as a walking atavism has ignited a caustic debate among academics. The opposing view is represented by “Alas, Poor Darwin”, a collection of essays edited by Hilary and Steven Rose.

Sixteen authors, among them biologists, sociologists, and anthropologists, condemn evolutionary psychology as a flagrant abuse of Darwinism, a mere trick to justify conservative political views and give biology dominion over the social sciences. Evolutionary psychology claims to be able to explain the “universals” of human culture, such as the male promiscuity and female sexual coyness supposedly seen in all societies. These traits are, it seems, evolutionary solutions to humanity’s ancient problems: finding a mate, learning a language and getting along with the neighbours. Each solution is coded into a “module”—a packet of nerve cells that fits with others, like Lego blocks, to build the human brain. Thus, a “fat module” makes us seek out fatty food, a scarce but valuable commodity to our ancestors. But because culture changes faster than our genes, such modules may now be harmful. With a McDonald’s on every corner, our evolved love of lipids can lead to an early grave.

Judging by the popularity of books by evolutionary psychologists such as Steven Pinker, Daniel Dennett and E.O. Wilson, the public has a strong appetite for such Darwinian tales. There is, of course, nothing inherently wrong with studying the history of human behaviour. Our bodies obviously evolved, so why not our minds? But evolutionary psychology faces (and often ignores) a central problem: how can we distinguish actions with an evolutionary basis from those that arose from the interaction between a big brain and a complex culture? Clearly, the many couples who forgo children for careers are not following the evolutionary programme. Although evolutionary psychology may try to argue its way out of this fact, it cannot explain it. Some traits such as breathing, sleeping, and sexual intercourse, have certainly evolved by natural selection. Others, like certain differences in sexual behaviour between men and women, may also be products of evolution. However, it is not obvious how other traits, such as depression or homosexuality, were of adaptive benefit to our ancestors.

Because it is all too easy to make up stories, one must draw a line between the scientifically plausible and implausible. But evolutionary psychologists have been notably reluctant to do so. That failure to police their own discipline has given them a bad name.

It is hard to understand the evolutionary forces that acted on our distant ancestors, whose environments and social organisation are forever beyond our ken. However, despite the frequent use of low standards of evidence, many evolutionary psychologists are strident and dogmatic. They urge society to infuse evolutionary ideas into social and legal policies, but do not bother to consider simpler explanations for our behaviour. Depression, for example, is claimed to be an evolved and adaptive response to an unsuccessful life: depressive withdrawal allows one to regroup and plot a new course. But might it not, like Alzheimer’s disease, be simply a pathology of the brain?

In spite of the many flaws in evolutionary psychology, “Alas, Poor Darwin” is, alas, far from a definitive critique. Many chapters have little or nothing to do with the topic, and deal instead with the authors’ pet sociological or biological theories. Other contributors attack the discipline only because it is politically incorrect, some even placing it in the lineage of Nazi racial eugenics. Such polemic may entertain its

writers, if not its readers, but does little to advance the debate. Scientific theories can certainly be influenced by politics, but in the end stand or fall on their scientific, and not their social, merit.

Unfortunately, this book is almost devoid of scientific criticism. Mary Midgley, a philosopher, has a penetrating analysis of meme theory, showing that the notion of “units of culture” is intellectually vacuous; and Stephen Jay Gould shows that natural selection is not the only evolutionary force influencing human behaviour. Many authors, however, simply reject evolutionary psychology’s reductionist, gene-centred approach for an equally feeble and nebulous holism—involving complex interactions between genes, culture and learning—which fails to suggest new ways to study human behaviour.

Most contributors dislike the political implications of evolutionary psychology, but can’t be bothered to come to grips with its scientific claims. They leave important questions unasked. Which human behaviours are likely to have evolved by natural selection? Surprisingly, the only answer is Mr Gould’s grudging allusion to gender differences in sexual behaviour. What standards of proof in evolutionary psychology will satisfy those who disdain it? Many of these writers would, it seems, reject any theory about the evolution of our behaviour, no matter what the evidence.

It seems reasonable to suggest, at least, that evolutionary analyses of human behaviour should meet the same standards used in good studies of animal behaviour. Under this criterion, most arguments about evolutionary psychology, both for and against, sink without a trace. It is sad that these arguments cannot be conducted with civility and respect. Almost all involved parties fall firmly into either the “pro” or “anti” camp—positions that have become only more polarised with time. Such is the case when politics supersedes science. Each camp needs to clean up its act. Evolutionary psychologists must curb their hubris, scour their own discipline for shoddy science, and stop attacking their adversaries for being sociologists or feminists. Their opponents must at least recognise the scientific claims at stake, admit that some human acts have an evolutionary basis, and refrain from portraying evolutionary psychologists as right-wing ideologues.

In spite of this work’s title, Darwin died neither poor nor unmourned—he was worth about £17m ($25.5m) in today’s money, and is buried in Westminster Abbey. He was extremely self-critical, stuck closely to the facts and avoided needless controversy. Neither the contents of “Alas, Poor Darwin” nor the arguments of evolutionary psychology will make him shift even slightly in his grave.

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About sponsorship

British fiction

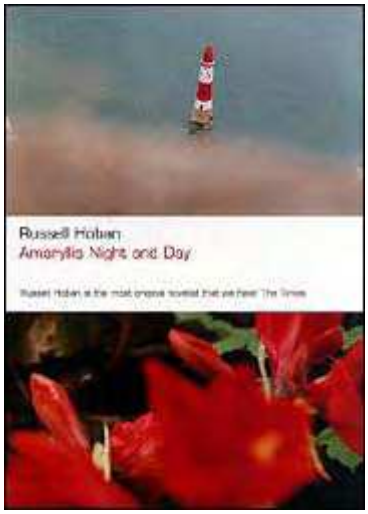
Life in a bottle

Jan 25th 2001
From The Economist print edition

AMARYLLIS NIGHT AND DAY
By Russell Hoban

Bloomsbury; 176 pages; £9.99.

Buy it at
Amazon.co.uk



RUSSELL HOBAN has straddled genres in his long and unpredictable career as a writer, vaulting playfully from classic children's books to sci-fi and on to contemporary fiction before turning back again with an unexpected twist. Readers without training in higher mathematics will need all the mental agility they can muster to follow him into the realm of pure geometry, which has inspired his tenth novel, "Amaryllis Night and Day".

If you follow the example of the thinly disguised narrator of the novel and type "Klein bottle" into an Internet search engine, hundreds of articles will be listed on your screen. Finding a definition, or a computer-generated image, of Klein's puzzling, inside-out closed bottle is easy enough, but understanding it mathematically poses a challenge. Rather than struggling with the definitions, Mr Hoban sensed that this bottle with a neck that passes through itself was a mystery, which contained a metaphor within it, and all at once he knew that he had found the theme for his next novel.

In spite of its geometrical provenance, "Amaryllis Night and Day" is a simple enough love story told in two dimensions: the waking and the dream world. Peter Diggs, an ageing American painter who, like the author, has long lived in London, has a passion for classical music, detailing Tube routes and drinking bitter with whisky chasers in old-fashioned pubs. He meets a woman in a dream; she is the woman of his dreams. A mysterious pre-Raphaelite beauty, Amaryllis begs Peter to follow her on to an eerie paper-lantern-like bus. Cowardice wakes him up and thereafter his life becomes a feverish pursuit of Amaryllis through the dream world (where she is tender and loving) to the waking world where the real Amaryllis is tense, neurotic and harbours a terrible secret.

Far from being strangers, it transpires that Peter's and Amaryllis's pasts are interlocked by guilt and experience in intricate, self-consuming ways, which make life seem more and more like a Klein bottle. And Mr Hoban draws on the old premise that you can manipulate waking life by the actions of your dreams to bring the novel to its conclusion.

Although there are traces of the Joycean mashing of conventional language which earned Mr Hoban so much critical acclaim in his post-apocalyptic cult novel, "Riddley Walker" (1980), the neologisms here are repetitive. In particular, Mr Hoban's division of the dream and waking worlds into "the glim and the unglim" becomes an irritant.

You want to admire Mr Hoban for his intellectual virtuosity and economy of style, but these are the very attributes that render his characters stilted and the story contrived. It may be a clash of generational taste, but it is hard to muster much enthusiasm for Peter, an old-fashioned kind of man who always buys the drinks yet goes home to paint women as either big-breasted harpies or romantically ethereal wraiths apparently doomed to death in paintings with titles like "The Beckoning Fair One". And Amaryllis, whom he describes as tasting "like sunwarmed wild strawberries, the blue skies and the high kites of long ago", fails to captivate the reader, coming across more as a neurotic than an exotic.

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Morris Lapidus

Jan 25th 2001
From The Economist print edition

Morris Lapidus, architect of make-believe, died on January 18th, aged 98

AP

WHEN the Fontainebleau was opened in Miami, its architect, Morris Lapidus, proudly spoke of it as “the world’s most pretentious hotel”. Pretentious? He quickly corrected the slip of the tongue: “flamboyant” was what he meant, of course. Yet a lexicographer might note that in its original Anglo-French meaning, of make-believe, pretentious was the precise word to describe Mr Lapidus’s style. He wanted the mostly ordinary holidaymakers who stepped into his hotels to feel that they were entering a wonderland. “I wanted people to walk in and drop dead,” he said. “I wanted them to say, ‘My God, this is luxury.’ ” Until Mr Lapidus built the Fontainebleau and other baroque hotels in Miami Beach in the 1950s, “luxury” had implied a quiet understatement.

If the hotel were modern it would tend to reflect the minimalist movement in architecture. To Mies van der Rohe’s dictum, “Less is more”, Morris Lapidus responded, “Too much is never enough”, which became the title of his autobiography. He believed in the virtues of vulgarity: lots of colour, lots of curves, lots of surprises. He put live alligators in a pool in the lobby of one hotel, so that guests would “know they were in Florida”. He thought about having monkeys swinging from trapezes, but decided they might damage the chandeliers. There were jokes, some of them witty: replicas of classical statues playing golf, or using the phone. Laughter is a background noise in a Lapidus foyer. He saw his hotels as theatres with the guests taking on roles as actors. You could pretend to be famous. Some guests were. Some scenes in the James Bond movie “Goldfinger” were filmed in the Fontainebleau.

Extravagance is now so commonplace that Mr Lapidus’s wild designs may no longer seem extreme. But they predated the Disney theme parks and the follies of Las Vegas. The guests at his hotels had seen such glamour only in films; and, like the old movie palaces, with their deep carpets and plastic finery, they provided a brief escape from the humdrum realities of everyday life. Showy Miami, best viewed through rhinestone sunglasses, was right for him. Others soon played his tune. Go there now and even the motels, with such names as Tangiers and Suez, seem exotic.

His critics

Morris Lapidus’s hotels were loved by, or at least charmed, almost everyone except writers on architecture, who saw them as a blasphemous assault on the holy writ of austere functionality. “Pornography of architecture” was one of the milder comments. Mr Lapidus said that during much of his long career his work was never published in an architectural journal, except to abuse it. “I was anathema,” he said. No one, though, doubted his acumen. He had a resemblance to another memorable American character, Sam Goldwyn, whose solecisms (“Never make forecasts, especially about the future”) concealed a brilliant Hollywood film maker. Both men were born in Eastern Europe, Goldwyn in Poland, Lapidus in Russia.

Growing up in Brooklyn, the big treat for Morris was a trip to Coney Island. What he called the “whirling, twisting, colourful” lights were to reappear in Miami Beach. But contracts to design hotels do not come to young architects just out of college. Mr Lapidus spent some 20 years designing shops, small and big, attracting customers by using colour, light and “sweeping, curving” interiors. In the Fontainebleau, the first of several hundred hotels he designed, he incorporated “all the things I had learned from my store work. When I got into hotels, I had to think, what am I selling now? I was selling a good time.”

Mr Lapidus was sometimes asked who were his own favourite architects. He would surprise questioners by mentioning Frank Lloyd Wright, an American traditionalist, and Le Corbusier, a Swiss-born architect famous for his massive box-like blocks of flats. But Mr Lapidus admired workmanship, whatever the architectural genre, just as a fashion designer such as John Galliano is praised for his painstaking craftsmanship however you view his crazy clothes. Mr Lapidus was a craftsman. One contribution he made to architecture that hotel users are grateful for is the short corridor. He recalled that when he was a young architect travelling a lot from town to town, at the end of a weary day he always seemed to have a long walk to find his hotel room. The hotels he designed are shaped to end those long walks.

In 1990, when Morris Lapidus was 88 and thinking of retiring, and a bit depressed that his life's work had gone unnoticed, he was suddenly discovered in Europe. His work, a critic noted, expressed the spirit of Main Street America. A Swiss publisher produced a tome entitled "Morris Lapidus: The Architect of the American Dream". Mr Lapidus was invited to the Netherlands for an exhibition about his work. American critics swallowed their pride and conceded that he had indeed had an influence. Last year he was named an "American original" at a ceremony at the White House in Washington. Some architects, Mr Lapidus noted, were starting to round the corners of their buildings. It was all quite pretentious, in a make-believe sort of way.

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OUTPUT, DEMAND AND JOBS

Jan 25th 2001
From The Economist print edition

In the year to November, the growth of the euro area's industrial output quickened to 4.4%; in France it slowed to 2.3%, compared with 5.6% a year earlier. Sweden's industrial production soared by 9.9% in the 12 months to November. The country's unemployment rate fell in December to only 3.7%, its lowest level for ten years.

% change at annual rate	GDP		The Economist poll GDP forecasts		Industrial production		Retail sales (volume)	Unemployment % rate	
	3 mths†	1 year	2000	2001	3 mths†	1 year	1 year	latest	year ago
Australia	+ 2.6	+ 4.2 Q3	+ 4.4	+ 3.3	– 1.5	+ 4.2 Q3*	– 0.8 Q3	6.6 Dec	7.0
Austria	+ 1.2	+ 1.9 Q3	+ 3.4	+ 2.5	na	+ 6.7 Oct*	+ 3.0 Sep	3.2 Nov	3.6
Belgium	+ 2.0	+ 3.2 Q3	+ 3.9	+ 2.8	na	– 0.2 Nov*	+ 6.1 Oct	10.7 Nov*	11.3
Britain	+ 2.8	+ 3.0 Q3	+ 3.0	+ 2.6	– 2.6	+ 0.3 Nov	+ 4.4 Dec	5.3 Nov‡	5.9
Canada	+ 4.8	+ 5.0 Q3	+ 4.9	+ 3.0	+ 2.3	+ 5.7 Oct	+ 5.4 Oct	6.8 Dec	6.8
Denmark	+ 2.0	+ 2.7 Q3	+ 2.6	+ 2.1	na	+ 2.6 Nov	+ 0.2 Oct	5.4 Dec	5.4
France	+ 2.3	+ 3.0 Q3	+ 3.2	+ 2.7	+ 3.6	+ 2.3 Nov	– 1.5 Nov	9.2 Nov	10.9
Germany	+ 2.3	+ 2.8 Q3	+ 3.1	+ 2.5	+ 3.9	+ 4.9 Nov	+ 0.5 Nov	9.2 Dec	10.2
Italy	+ 2.4	+ 2.5 Q3	+ 2.6	+ 2.2	+ 1.9	+ 2.4 Nov	– 1.5 Oct	10.5 Jul	11.4
Japan	+ 1.0	+ 1.4 Q3	+ 1.8	+ 1.6	– 3.2	+ 3.3 Nov	– 0.3 Nov	4.8 Nov	4.6
Netherlands	+ 2.8	+ 3.3 Q3	+ 3.9	+ 3.1	– 1.4	+ 2.2 Nov	+ 0.4 Oct	2.6 Dec§	2.7
Spain	+ 2.2	+ 3.9 Q3	+ 4.0	+ 3.2	– 0.5	+ 4.0 Nov	na	13.6 Nov	15.1
Sweden	+ 3.9	+ 4.0 Q3	+ 4.0	+ 3.4	na	+ 9.9 Nov	+ 4.0 Nov	3.7 Dec*	5.3
Switzerland	+ 2.0	+ 3.6 Q3	+ 3.4	+ 2.3	na	+ 6.9 Q3*	– 3.3 Nov	1.9 Dec*	2.5
United States	+ 2.2	+ 5.2 Q3	+ 5.1	+ 2.3	– 1.1	+ 3.1 Dec	+ 4.2 Nov	4.0 Dec	4.1
Euro area	+ 2.8	+ 3.4 Q3	+ 3.4	+ 2.9	+ 5.4	+ 4.4 Nov	+ 1.0 Oct	8.8 Nov	9.6
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*								
Finland	+ 7.0	+ 5.6 Q3	na	na	+21.5	+17.3 Nov	+ 5.3 Sep	8.3 Dec*	9.1
Greece	na	+ 3.7 1999	na	na	na	– 7.2 Aug	+ 9.7 Aug	na	na
Iceland	na	+ 4.4 1999	na	na	na	+ 4.2 1999	na	1.1 Nov	1.5
Ireland	+ 5.3	+11.7 Q1	na	na	+31.0	+ 5.2 Jul	+10.6 Oct	3.6 Dec	4.7
Luxembourg	na	+ 7.5 1999	na	na	na	– 1.9 Oct*	+ 7.9 Aug	2.6 Nov	2.8
New Zealand	+ 2.7	+ 2.4 Q3	na	na	na	+11.5 Q3*	+ 1.7 Q3	5.7 Q3	6.6
Norway	+ 1.3	+ 1.0 Q3	na	na	+ 6.8	– 0.3 Nov	– 0.5 Nov	3.5 Q3	3.3
Portugal	+ 0.8	+ 2.6 Q2	na	na	na	+ 0.8 Nov*	+ 3.8 Oct	3.4 Q3	4.2

*Not seasonally adjusted. †Average of latest 3 months compared with average of previous 3 months, at annual rate. ‡Sep-Nov; claimant count rate 3.6% in December. §Oct-Dec.

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COMMODITY PRICE INDEX

Jan 25th 2001
From The Economist print edition

The Association of Coffee Producing Countries (ACPC) says that its scheme to stockpile beans met 88% of its 4m-bag target in the fourth quarter of 2000. Brazil and Vietnam withheld more coffee than requested, but Indonesia's producers were slow starters because of delays in government funding. Brazil may drop out of the scheme, which has cost $400m in lost exports, if other members fail to pull their weight. Since the plan was agreed in May, average coffee prices have fallen by nearly 30% to 50 cents a pound. The ACPC wants to raise them to 95 cents. But world coffee output is nearing its third year of surplus, and consumers are using less pre-packaged ground coffee (which uses more beans per cup). A big recovery in prices is unlikely.

1995=100	Jan 16th	Jan 23rd*	% change on one month	% change on one year
Dollar index				
All items	72.6	73.5	+ 0.6	– 2.4
Food	72.0	72.4	nil	+ 0.5
Industrials				
All	73.5	73.1	– 1.4	– 8.5
Nfa†	66.9	66.5	– 1.7	– 8.0
Metals	79.0	82.3	+ 3.5	– 4.6
Sterling index				
All items	77.9	78.8	+ 1.2	+ 9.4
Food	77.2	77.6	+ 0.6	+ 12.7
Industrials	78.8	80.5	+ 1.9	+ 5.4
Euro index				
All items	101.5	103.0	– 0.5	+ 4.5
Food	100.7	101.4	– 1.1	+ 7.7
Industrials	102.7	105.1	+ 0.2	+ 0.7
Yen index				
All items	91.0	91.5	+ 3.6	+ 7.9
Food	90.3	90.1	+ 3.0	+ 11.1
Industrials	92.1	93.5	+ 4.4	+ 3.9
Gold				
$ per oz	264.50	266.20	– 2.7	– 7.6
Crude oil North Sea Brent				
$ per barrel	26.00	26.49	+ 11.0	nil
West Texas Intermediate				
$ per barrel	30.28	29.51	+ 13.3	+ 2.9

* Provisional. † Non-food agriculturals.

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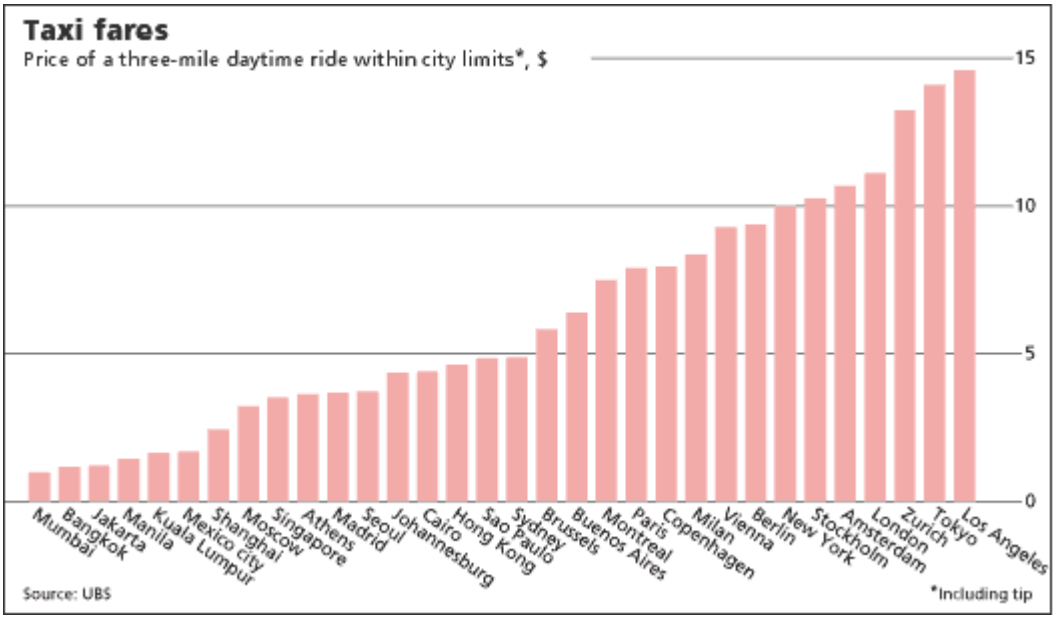
CITY TRAVEL

Jan 27th 2001
From The Economist print edition

The price of a cab ride varies dramatically around the world. Top of the league for the most expensive journey is Los Angeles, followed by Tokyo and Zurich. In any of these three cities, a three-mile taxi trip will set you back more than $13. By contrast, it costs $1.20 or less in the three cheapest cities of the 58 surveyed by UBS in “Prices and Earnings around the Globe”, an annual study of purchasing power. Comparing regions, costs are highest in North America and Western Europe, at an average of $8.30 a trip. The average cost is $4.75 in South America and $4.35 in Asia. Across all the surveyed cities, the average is $6. Travellers can, however, find cheaper deals in Asian and South American cities, where six-mile journeys by public transport cost an average of $0.73 and $0.54, respectively.



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PRICES AND WAGES

Jan 25th 2001
From The Economist print edition

Consumer-price inflation in the euro area slowed to 2.6% in the 12 months to December. In the same period it was unchanged in Canada at 3.2%, the highest rate for nine years. Australia's year-on-year consumer-price inflation slowed to 5.8% in the fourth quarter, but the 12-month rise in producer prices quickened to 8.4%.

% change at annual rate	Consumer prices*		The Economist poll consumer prices forecast		Producer prices*		Wages/earnings	
	3 mths†	1 year	2000	2001	3 mths†	1 year	3 mths†	1 year
Australia	+ 1.2	+ 5.8 Q4	+ 4.6	+ 4.0	+10.2	+ 8.4 Q4	+ 8.1	+ 6.8 Q3
Austria	+ 2.8	+ 2.6 Dec	+ 2.1	+ 1.6	+ 4.4	+ 4.4 Dec	+ 1.9	+ 2.2 Dec
Belgium	+ 1.3	+ 2.5 Dec	+ 2.6	+ 2.1	+16.2	+10.0 Nov	+ 3.7	+ 1.6 Q4
Britain	+ 2.5	+ 2.9 Dec	+ 2.4	+ 2.3	+ 1.6	+ 2.4 Dec	+ 5.7	+ 4.4 Nov
Canada	+ 2.5	+ 3.2 Dec	+ 2.7	+ 2.4	+ 5.0	+ 5.2 Nov	+ 2.6	+ 4.1 Oct
Denmark	+ 2.7	+ 2.4 Dec	+ 2.9	+ 2.3	+ 3.0	+ 3.9 Dec	+ 7.0	+ 3.8 Q3
France	+ 1.7	+ 1.6 Dec	+ 1.8	+ 1.6	+ 7.2	+ 5.9 Nov	+ 4.6	+ 5.3 Q3
Germany	+ 0.9	+ 2.2 Dec	+ 1.9	+ 1.6	+ 5.3	+ 5.1 Dec	na	+ 1.8 Nov*
Italy	+ 2.9	+ 2.7 Dec	+ 2.5	+ 2.1	+ 7.0	+ 6.7 Nov	+ 1.9	+ 1.8 Nov*
Japan	+ 0.9	− 0.5 Nov	− 0.7	− 0.4	− 0.1	+ 1.1 Dec	na	nil Nov
Netherlands	+ 3.3	+ 2.9 Dec	+ 2.4	+ 3.1	+10.1	+ 9.0 Nov	+ 3.0	+ 2.9 Nov
Spain	+ 3.4	+ 4.0 Dec	+ 3.4	+ 2.9	+ 6.5	+ 5.7 Nov	+ 3.2	+ 2.4 Q3
Sweden	na	+ 1.4 Dec	+ 1.3	+ 1.7	+ 6.7	+ 3.7 Dec	− 4.2	+ 2.9 Oct*
Switzerland	+ 1.9	+ 1.5 Dec	+ 1.7	+ 1.5	+ 1.8	+ 2.2 Dec	na	+ 0.2 1999
United States	+ 2.7	+ 3.4 Dec	+ 3.3	+ 2.6	+ 3.5	+ 3.6 Dec	+ 4.6	+ 4.2 Dec
Euro area	+ 2.1	+ 2.6 Dec	+ 2.3	+ 2.0	+ 7.7	+ 6.3 Nov	+ 1.2	+ 1.8 Q3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Finland	+ 2.1	+ 3.5 Dec	na	na	+ 5.4	+ 6.0 Dec	+ 1.3	+ 4.4 Q3*
Greece	+12.6	+ 3.9 Dec	na	na	+13.8	+ 9.0 Nov	na	na
Iceland	+ 4.4	+ 3.5 Jan	na	na	+ 2.8	+ 4.4 Jan	+ 1.9	+ 7.6 Dec
Ireland	+ 5.7	+ 5.9 Dec	na	na	+ 4.2	+ 4.5 Dec	− 5.7	+ 6.1 Q1*
Luxembourg	+ 5.5	+ 3.5 Dec	na	na	+ 1.2	+ 5.2 Oct	+11.7	+ 4.9 Sep*
New Zealand	+ 4.7	+ 4.0 Q4	na	na	+16.1	+ 8.0 Q3	+ 1.1	+ 1.5 Q3
Norway	+ 3.7	+ 3.0 Dec	na	na	+ 2.8	+ 3.8 Dec	+ 2.9	+ 3.8 Q3*
Portugal	+ 4.1	+ 3.9 Dec	na	na	+16.0	+16.7 Nov	na	+ 3.0 Nov*

*Not seasonally adjusted. †Average of latest 3 months compared with average of previous 3 months, at annual rate.

Text refers only to the first 16 countries listed

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MONEY AND INTEREST RATES

Jan 25th 2001
From The Economist print edition

The Bank of Canada followed the Federal Reserve in lowering interest rates, but by only a quarter of a point. American government-bond yields rose on fears that the Fed would also cut rates by only a quarter of a point on January 31st.

	Money supply* % rise on year ago			Interest rates % p.a. (Jan 24th 2001)							
				over-	3-mth money market		banks	2-year	10-year gov't		corporate
	narrow	broad		night	latest	year ago	prime	gov't bonds	latest†	year ago	bonds
Australia	+ 9.9	+ 4.8	Nov	6.25	5.95	5.70	9.00	4.90	5.41	7.20	7.27
Britain	+ 4.8	+ 8.2	Dec	6.25	5.75	6.03	7.00	5.29	4.86	5.69	6.12
Canada	+14.2	+ 8.0	Dec	5.43	5.26	5.06	7.25	5.10	5.52	6.44	7.12
Denmark	na	+ 1.8	Dec	4.90	5.38	3.70	8.00	5.00	5.16	5.76	7.33
Japan	+ 4.3	+ 2.2	Dec	0.24	0.42	0.05	1.50	0.30	1.46	1.63	1.62§
Sweden	+ 1.9	+ 2.1	Dec	4.00	4.07	3.63	4.60	4.18	4.95	5.86	4.92
Switzerland	– 2.6	– 1.7	Dec	3.51	3.44	1.91	5.63	3.23	3.48	3.61	4.45
United States	– 3.0	+ 8.6	Dec	6.06	5.35	5.85	9.00	4.85	5.31	6.82	7.13
Euro area‡	+ 5.0	+ 4.9	Nov	4.76	4.68	3.33	4.55	4.47	4.82	5.44	5.71

†France 4.97, Germany 4.82, Italy 5.26. Benchmarks: Japan No.227 1.49, US 30-yr 5.67. ‡Germany for prime and bonds. §New series.

*Narrow: M1 except Britain M0, broad: M2 or M3 except Britain M4.Sources: Commerzbank, Den Danske, J.P. Morgan Chase, Royal Bank of Canada, Svenska Handelsbanken, Warburg Dillon Read, WEFA Group, Westpac, Thomson Financial Datastream.Rates cannot be construed as banks' offers.

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CURRENCY PROJECTIONS

Jan 27th 2001
From The Economist print edition

The euro's recent rally against the dollar should continue over the next three months, according to quarterly estimates by J.P. Morgan Chase. In a year's time, however, the single currency is expected to be worth roughly the same as it is now. The yen is predicted to follow the opposite course, first falling and then rallying, to an eventual rate of 113 to the dollar in January 2002. The forecasts imply that sterling will depreciate by roughly the same amount against the euro and the dollar over the next 12 months. Of the 16 currencies in the chart, only the Mexican peso and the South African rand are expected both to be weaker in three months' time and to be weaker still in a year. Only the Australian and Canadian dollars are forecast to rise and rise again. The Australian dollar's 11% rise against the greenback is the largest predicted move.

Exchange-rate forecasts
Currency units per $

	Jan 24th	3-month	12-month
Euro area*	0.92	0.98	0.92
Japan	118	122	113
Australia	1.84	1.72	1.67
Britain†	1.46	1.56	1.42
Canada	1.51	1.49	1.45
Denmark	8.09	7.61	8.11
Sweden	9.65	8.93	9.35
Switzerland	1.66	1.58	1.72
China	8.28	8.28	8.28
Singapore	1.74	1.74	1.71
South Korea	1,269	1,330	1,220
Brazil	1.96	1.93	2.00
Mexico	9.73	9.95	10.6
Poland	4.10	4.08	4.26
Russia	28.4	28.0	28.0
South Africa	7.88	7.90	8.00

Source: J.P. Morgan Chase *$ per euro †$ per £

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TRADE, EXCHANGE RATES AND BUDGETS

Jan 25th 2001
From The Economist print edition

America's merchandise-trade deficit narrowed in November to $39.0 billion, but the 12-monthly total continued to widen, reaching $441.7 billion. Canada's exports of electricity benefited from California's crisis, but imports of fuel surged; in November, its trade surplus narrowed to $2.9 billion. Its 12-month surplus, however, rose to $33.6 billion, 50% more than a year ago.

	Trade balance*, $bn		Current account		Exchange rate		Currency units				Budget balance % of GDP 2000[5]
	latest month	latest 12 months	$bn latest 12 mths	The Economist poll % of GDP, forecast 2000	2001	trade-weighted[†] Jan 24th	year ago	per $ Jan 24th	per $ year ago	per £	per euro	per ¥100	
Australia	− 0.09 Nov	− 5.6	− 17.8 Q3	-4.3	-3.5	74.2	82.1	1.64	1.54	2.68	1.70	1.56	0.9
Austria	− 0.41 Oct[‡]	− 4.0	− 4.4 Nov	-2.6	-2.9	100.5	100.7	14.9	13.7	21.7	13.8	12.62	-1.6
Belgium	+ 1.89 Oct[‡]	+ 13.5	+ 10.3 Sep	4.1	4.0	98.3	99.5	40.7	40.3	63.7	40.3	37.0	-0.1
Britain	− 3.05 Nov	− 42.4	− 16.3 Q3	-1.5	-1.9	104.4	109.5	0.69	0.61	–	0.63	0.58	2.7
Canada	+ 2.91 Nov	+ 33.6	+ 7.7 Q3	1.2	0.6	79.0	81.7	1.51	1.44	2.21	1.40	1.28	2.5
Denmark	+ 0.37 Nov	+ 4.3	+ 2.6 Nov	1.3	1.3	101.9	101.6	8.09	7.43	11.9	7.46	6.99	2.7
France	+ 0.01 Nov	+ 2.9	+ 26.9 Oct	2.3	1.9	102.1	102.4	7.11	6.55	10.4	6.56	6.02	-1.4
Germany	+ 2.22 Nov	+ 52.7	− 29.2 Nov	-1.3	-0.9	99.0	99.5	2.12	1.95	3.09	1.96	1.79	1.4
Italy	− 0.97 Oct	+ 2.9	− 5.9 Oct	-0.3	-0.3	72.8	73.2	2.088	1.934	3.059	1.936	1.776	-0.1
Japan	+ 8.19 Nov	+ 120.5	+ 120.0 Nov	2.5	2.2	140.7	150.7	118	106	172	109	–	-8.0
Netherlands	+ 1.01 Oct[‡]	+ 12.5	+ 13.9 Q3	4.9	4.4	98.3	98.4	2.39	2.20	3.49	2.20	2.02	1.6
Spain	− 3.40 Oct	− 39.5	− 19.2 Oct	-3.5	-3.1	74.5	74.6	190	166	269	166	153	-0.3
Sweden	+ 1.15 Nov	+ 14.6	+ 5.9 Nov	2.1	2.1	79.1	82.8	9.65	8.53	14.1	8.90	8.17	3.4
Switzerland	− 0.07 Nov[§]	− 1.1	+ 32.5 Q3	11.9	11.2	108.2	102.9	1.66	1.61	2.42	1.53	1.40	na
United States	− 39.00 Nov	− 441.7	− 415.5 Q3	-4.4	-4.2	115.3	105.8	–	–	1.46	0.92	0.85	2.3
Euro area	+ 3.16 Oct[‡]	+ 16.8	− 21.9 Oct	-0.3	-0.2	80.7	81.4	1.08	1.00	1.59	–	0.92	0.3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*												
Finland	+ 0.95 Nov[§]	+ 13.3	+ 8.9 Nov	na	na	78.2	77.8	6.44	5.94	9.39	5.94	5.45	4.0
Greece	− 1.80 Q3	− 7.2	− 7.6 Sep	na	na	57.6	59.3	369	331	538	341	312	-1.0
Iceland	− 0.03 Nov[§]	− 0.5	− 0.7 Q2	na	na	na	na	86.3	72.7	126	79.6	73.0	2.8
Ireland	+ 2.85 Oct	+ 26.0	+ 0.2 Q3	na	na	88.2	88.0	0.85	0.79	1.24	0.78	0.72	5.6
Luxembourg	− 0.18 Oct	− 2.6	+ 1.6 Q3	na	na	99.8	99.5	40.7	40.3	63.7	40.3	37.0	na
New Zealand	− 0.17 Nov[§]	− 1.2	− 3.3 Q3	na	na	81.2	85.5	2.28	1.97	3.32	2.10	1.93	0.5
Norway	+ 2.17 Nov	+ 25.5	+ 19.2 Oct	na	na	93.1	94.2	8.91	8.07	13.0	8.22	7.54	14.0
Portugal	− 1.00 Sep[§]	− 15.0	− 11.0 Nov	na	na	99.6	99.5	217	200	316	200	184	-1.5

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †1990=100, Bank of England. ‡OECD estimate. §Not seasonally adjusted.

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STOCKMARKETS

Jan 25th 2001
From The Economist print edition

Renewed confidence in high-tech shares pushed the Nasdaq Composite index up by 6.6%. The Nikkei 225 rose for seven days in a row, but it slipped back after the Japanese economics minister resigned and computer makers warned of lower profits.

Market indices	Jan 24th	2000-01 high	2000-01 low	% change on one week	% change on one year	% change on record high	% change on Dec 31st 1999 in local currency	% change on Dec 31st 1999 in $ terms
Australia (All Ordinaries)	3,245.1	3,330.4	2,920.0	+ 1.5	+ 5.4	– 2.6	+ 2.9	– 14.4
Austria (ATX)	1,087.8	1,236.1	1,029.4	– 1.3	– 5.1	– 37.4	– 9.2	– 16.4
Belgium (Bel 20)	2,994.1	3,340.4	2,532.2	+ 0.6	+ 4.0	– 18.7	– 10.4	– 17.5
Britain (FTSE 100)	6,264.4	6,930.2	5,994.6	+ 1.1	– 1.7	– 9.6	– 9.6	– 18.2
Canada (Toronto Composite)	9,306.2	11,388.8	8,114.2	+ 4.8	+ 8.4	– 18.3	+ 10.6	+ 6.0
Denmark (Copenhagen SE)	1,002.1	1,039.0	755.1	+ 4.3	+ 28.0	– 3.5	+ 29.4	+ 18.8
France (SBF 250)	3,761.1	4,390.7	3,512.8	+ 0.5	+ 3.1	– 14.3	– 1.3	– 9.1
Germany (Xetra DAX)	6,706.7	8,065.0	6,200.7	+ 0.8	– 3.8	– 16.8	– 3.6	– 11.3
Italy (BCI)	1,938.1	2,182.3	1,666.4	+ 0.6	+ 8.9	– 11.2	+ 6.7	– 1.8
Japan (Nikkei 225)	13,893.6	20,833.2	13,201.1	+ 1.7	– 27.3	– 64.3	– 26.6	– 36.1
(Topix)	1,304.1	2,507.6	1,230.1	+ 1.8	– 21.6	– 54.8	– 24.3	– 34.1
Netherlands (EOE)	635.9	701.6	612.4	– 1.0	– 0.2	– 9.4	– 5.3	– 12.8
Spain (Madrid SE)	961.8	1,146.2	857.9	+ 1.1	– 3.0	– 16.1	– 4.6	– 12.2
Sweden (Affarsvarlden Gen)	5,010.9	6,960.6	4,558.5	+ 0.2	– 11.8	– 28.0	– 8.9	– 19.3
Switzerland (Swiss Market)	7,940.0	8,377.0	6,781.4	– 0.4	+ 14.0	– 5.6	+ 4.9	+ 1.3
United States (DJIA)	10,647.0	11,723.0	9,796.0	+ 0.6	– 3.5	– 9.2	– 7.4	– 7.4
(S&P 500)	1,364.3	1,527.5	1,264.7	+ 2.6	– 2.8	– 10.7	– 7.1	– 7.1
(Nasdaq Comp)	2,859.2	5,048.6	2,291.9	+ 6.6	– 29.7	– 43.4	– 29.7	– 29.7
Europe (FTSE Eurotop 300) *	1,541.2	1,705.0	1,472.5	+ 0.6	+ 2.0	– 9.6	– 2.7	– 10.4
Euro area (FTSE Ebloc 100) *	1,397.6	1,550.5	1,277.7	– 0.1	+ 4.6	– 9.9	+ 0.9	– 7.1
World (MSCI) †	1,236.4	1,448.8	1,178.2	+ 1.4	– 8.8	– 14.7	na	– 13.0
World bond market (Salomon) ‡	437.7	447.8	414.8	– 0.6	+ 1.0	– 4.8	na	+ 0.1

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms.
‡Salomon Smith Barney World Government Bond Index, total return, in dollar terms.

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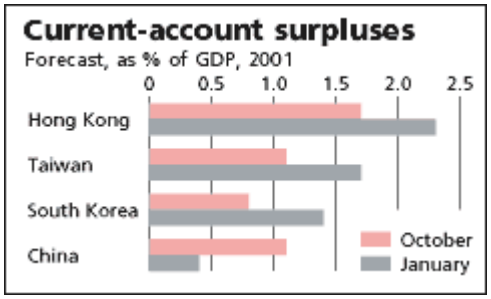
ECONOMIC FORECASTS

Jan 25th 2001
From The Economist print edition

Every three months *The Economist* polls a group of forecasters and calculates the average of their predictions for growth and current-account balances for 25 emerging economies. Since our last poll in October, the panel has made several adjustments to its predictions for current-account balances. The biggest changes are in East Asia; a stall in China's negotiations to join the World Trade Organisation has dramatically lowered forecasts of its current-account surplus in 2001. Hong Kong, Taiwan and South Korea appear ready to pick up the slack—expectations for their surpluses all rose.



In October, our analysts raised their expectations of GDP growth in 2001 for 14 of our 25 developing countries (which then included Greece rather than Peru). This time they have lowered their forecasts for 19, with the only good news coming from Venezuela. Its oil-rich GDP should rise by 3.7% rather than the 3.5% predicted earlier. Forecasts for Brazil, Egypt, the Czech Republic and Russia did not change.

The Economist poll of forecasters

January	Real GDP % change		Current account % of GDP	
	2000	2001	2000	2001
China	8.0	7.5	1.2	0.4
Hong Kong	10.2	4.1	4.0	2.3
India	6.1	6.1	–1.3	–1.2
Indonesia	4.5	3.5	5.5	3.6
Malaysia	8.7	4.7	10.2	6.0
Philippines	3.9	2.3	10.1	9.5
Singapore	9.9	5.2	21.9	18.4
South Korea	9.2	4.2	2.1	1.4
Taiwan	6.2	4.5	1.7	1.7
Thailand	4.3	3.5	7.2	6.1
Argentina	nil	2.3	–3.6	–3.7
Brazil	4.0	4.1	–4.3	–4.3
Chile	5.6	5.1	–1.5	–2.2
Colombia	3.0	3.3	–0.7	–2.2
Mexico	7.2	3.7	–3.2	–3.9
Peru	3.7	1.8	–2.7	–2.6
Venezuela	3.1	3.7	12.2	5.2
Egypt	5.2	4.8	–1.2	–1.6
Israel	5.4	3.4	–0.9	–2.1
South Africa	3.0	3.3	–0.4	–1.0
Turkey	6.0	2.5	–4.5	–3.0
Czech Republic	2.7	3.3	–3.9	–4.1
Hungary	5.3	5.1	–3.8	–4.4
Poland	4.5	3.9	–6.4	–5.6
Russia	7.0	4.7	19.4	11.7

Sources: ABN Amro; Deutsche Bank; EIU; Goldman Sachs; HSBC; ING Barings; J.P.Morgan; Merrill Lynch; Salomon Smith Barney; Warburg Dillon Read.

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FINANCIAL MARKETS

Jan 25th 2001
From The Economist print edition

All the Asian markets in our table rose after Gloria Macapagal Arroyo's peaceful replacement of Joseph Estrada as president of the Philippines. Manila rose by 17.6% on January 22nd; it gained 14.2% over the week. Tel Aviv lost 5.0% after the killing of two Israelis led to a breakdown in peace talks with the Palestinians on January 23rd.

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Jan 24th		Dec 31st 1999	
	Jan 24th	year ago	Jan 24th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	12.1	5.40	2,185.2‡	+ 1.5	+ 50.5	+ 50.5
Hong Kong	7.80	7.78	11.4	5.30	16,044.2	+ 5.1	– 5.4	– 5.7
India	46.4	43.6	67.6	8.87	4,326.4	+ 6.0	– 13.6	– 18.9
Indonesia	9,400	7,435	13,701	15.02	417.0	+ 0.6	– 38.4	– 53.8
Malaysia	3.80	3.80	5.54	3.30	711.0§	+ 4.6	– 12.5	– 12.5
Philippines	48.5	40.5	70.6	16.13	1,665.4	+14.2	– 22.3	– 35.4
Singapore	1.74	1.69	2.54	2.50	1,914.2	+ 0.4	– 22.8	– 26.2
South Korea	1,269	1,128	1,850	6.37	627.5§	+ 5.3	– 39.0	– 45.5
Taiwan	32.6	30.8	47.4	5.25	5,847.9**	+ 1.4	– 30.8	– 33.3
Thailand	43.1	37.5	62.9	3.13	325.6	+ 3.4	– 32.4	– 41.1
Argentina	1.00	1.00	1.46	7.31	532.9	+ 4.4	– 2.9	– 2.9
Brazil	1.96	1.78	2.86	15.65	17,771.8	+ 3.4	+ 4.0	– 5.0
Chile	568	517	827	4.38*	5,106.0	+ 1.0	– 1.2	– 7.8
Colombia	2,253	1,961	3,284	13.33	728.5	+ 2.4	– 27.0	– 39.2
Mexico	9.73	9.51	14.2	17.07	6,311.9	+ 3.8	– 11.5	– 13.7
Peru	3.53	3.50	5.1	11.18	1,289.0	+ 2.9	– 29.8	– 30.2
Venezuela	700	654	1,020	13.37	8,186.8	+ 6.3	+ 51.1	+ 40.1
Egypt	3.86	3.43	5.63	9.09	7,356.8	+ 0.9	– 43.5	– 50.0
Israel	4.15	4.08	6.04	5.93	453.6	– 5.0	– 6.9	– 6.6
South Africa	7.88	6.17	11.5	10.45	8,832.6	+ 1.0	+ 3.4	– 19.2
Turkey	677,540	551,875	987,582	39.00	10,884.6	– 0.5	– 28.4	– 42.7
Czech Republic	37.9	35.8	55.2	5.34	508.4	– 0.5	+ 3.8	– 1.6
Hungary	287	255	419	11.35	8,042.7	– 1.0	– 8.8	– 19.4
Poland	4.10	4.13	5.98	18.93	17,286.7	+ 1.8	– 4.4	– 3.5
Russia	28.4	28.6	41.4	25.00	174.4†	+ 2.6	+ 1.3	– 1.8

*Inflation-adjusted. †In dollar terms. ‡Jan 19th. §Jan 22nd. **Jan 18th.

Sources: National statistics offices, central banks and stock exchanges; Primark Datastream; EIU; Reuters; Warburg Dillon Read; J.P. Morgan; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Bank Ekspres; Deutsche Bank; *Russian Economic Trends*.

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ECONOMY

Jan 25th 2001
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Taiwan's industrial output fell by 2.1% in the 12 months to December; but for 2000 as a whole, it was still 7% up on 1999. The Czech Republic's trade deficit widened to $3.3 billion in 2000. The annual rate of consumer-price deflation in Hong Kong slowed to 1.8% in December; prices have been falling there for 26 months.

	% change on year earlier			Latest 12 months, $bn		Foreign reserves*, $bn	
	GDP	Industrial production	Consumer prices	Trade balance	Current account	Latest	Year ago
China	+ 7.4 Q4	+10.4 Dec	+ 1.5 Dec	+24.1 Dec	+15.7 1999	163.9 Nov	156.8
Hong Kong	+10.4 Q3	− 0.1 Q3	− 1.8 Dec	−10.6 Nov	+ 9.2 Q3	107.5 Dec	96.3
India	+ 7.2 Q4†	+ 2.7 Nov	+ 2.7 Nov	− 9.0 Nov	− 5.6 Q3	37.3 Dec	32.7
Indonesia	+ 5.1 Q3	+38.4 Q4†	+ 9.4 Dec	+28.6 Nov	+ 6.2 Q1	29.0 Nov	26.3
Malaysia	+ 7.7 Q3	+11.1 Nov	+ 1.4 Dec	+16.8 Nov	+11.3 Q2	29.6 Nov	29.8
Philippines	+ 4.8 Q3	+21.0 Oct	+ 6.6 Dec	+ 5.7 Nov	+ 9.1 Aug	12.5 Oct	12.8
Singapore	+10.5 Q4	+17.1 Nov	+ 2.0 Nov	+ 4.0 Nov	+21.6 Q3	77.5 Nov	74.3
South Korea	+ 9.2 Q3	+ 6.4 Nov	+ 3.2 Dec	+12.1 Dec	+11.7 Nov	96.2 Dec	74.0
Taiwan	+ 6.6 Q3	− 2.1 Dec	+ 1.7 Dec	+ 8.4 Dec	+ 7.5 Q3	108.2 Nov	103.5
Thailand	+ 2.6 Q3	− 2.0 Nov	+ 1.3 Dec	+ 5.8 Nov	+ 9.5 Nov	31.7 Nov	32.1
Argentina	nil Q3	− 1.6 Dec	− 0.7 Dec	+ 0.6 Nov	−10.5 Q3	22.4 Nov	24.5
Brazil	+ 4.5 Q3	+ 4.9 Nov	+ 5.3 Dec	− 0.7 Dec	−24.9 Nov	32.5 Nov	42.2
Chile	+ 5.8 Q3	− 0.8 Nov	+ 4.5 Dec	+ 1.5 Dec	− 0.7 Q3	14.2 Nov	14.1
Colombia	+ 3.1 Q3	+11.2 Nov	+ 8.8 Dec	+ 2.2 Oct	+ 0.1 Q2	8.1 Dec	7.6
Mexico	+ 7.1 Q3	+ 4.6 Nov	+ 9.0 Dec	− 8.0 Dec	−16.4 Q3	34.7 Nov	31.7
Peru	+ 0.1 Nov	+ 0.9 Nov**	+ 3.7 Dec	− 0.4 Nov	− 1.6 Q3	8.6 Oct	9.0
Venezuela	+ 3.3 Q3	na	+ 13.4 Dec	+14.4 Jul	+11.8 Q3	14.3 Oct	11.8
Egypt	+ 6.5 2000‡	+ 9.4 2000‡	+ 2.5 Oct	−10.8 Q3	− 0.9 Q3	13.3 Sep	15.9
Israel	+ 7.3 Q3	+ 6.0 Nov	nil Dec	− 6.9 Dec	− 0.7 Q3	23.1 Dec	22.6
South Africa	+ 4.5 Q3	+ 3.6 Nov	+ 7.1 Nov	+ 2.6 Nov	− 0.7 Q3	6.1 Oct	5.9
Turkey	+ 7.4 Q3	+10.5 Nov	+ 39.0 Dec	−25.7 Oct	− 9.2 Oct	18.8 Nov	22.7
Czech Republic	+ 2.2 Q3	+ 4.3 Nov	+ 4.0 Dec	− 3.3 Dec	− 1.9 Q3	13.1 Dec	12.9
Hungary	+ 4.6 Q3	+13.4 Nov	+ 10.1 Dec	− 2.2 Nov	− 0.6 Nov	10.8 Nov	10.9
Poland	+ 3.3 Q3	− 2.2 Dec	+ 8.5 Dec	−11.7 Nov	−11.6 Oct	24.6 Nov	24.5
Russia	+ 7.9 Q3	+ 2.5 Dec	+ 20.2 Dec	+57.3 Oct	+43.8 Q3	24.0 Nov	7.6
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*						
Pakistan	+ 3.9 1999‡	+ 4.2 Jun	+ 4.9 Nov	− 2.0 Nov	− 2.5 1999	1.1 Sep	1.5
Saudi Arabia	+ 0.4 1999	na	− 1.0 Oct	+24.9 1999	− 1.7 1999	16.4 Sep	14.1

*Excluding gold, except Singapore; IMF definition. †1999. ‡Year ending June. **New series

Text refers only to the first 25 countries listed

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